

A Work Project presented as part of the requirements for the Award of a Master Degree in Finance from the  
NOVA – School of Business and Economics.

Marks & Spencer  
Out of Fashion  
The Case of An Outdated Brick and Mortar

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## **Abstract**

The current paper provides a thorough analysis of Marks & Spencer's stock performance. The analysis explores the arguments which support a SELL recommendation. For the purpose, a detailed analysis of the UK Food and Fashion retail industries is conducted, following an overview of the company's historical background and financial performance. The paper places special emphasis on the company's future value drivers and potential risks for the investment decision.

## **Keywords**

Marks & Spencer, Retail, Fashion, Grocery

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**MARKS AND SPENCER**

*FASHION*

STUDENT: BEATRIZ LEITE AND BERNARDO FARIA

**COMPANY REPORT**

6 JANUARY 2020

**Out-of-Fashion**

*The case of an outdated brick-and-mortar*

- We initiate coverage of Marks & Spencer (M&S) with a SELL recommendation and a Dec-20 TP of 190p (Bull Scenario), implying a 10% downside vs the current market price (19-Dec-19).
- The Food sector in the UK is struggling with severe competition from European discount retailers. In a scenario in which the company is attempting to deviate from a premium image and become a “family based shopper”, M&S is at risk of being “stuck in the middle”. Additionally, the company’s newly formed joint-venture with Ocado presents significant executional risks and puts at jeopardy the firm’s credibility to investors, following the recent dividend cut to finance the transaction.
- In Clothing & Home (C&H), stores are oversized and supply chain allows for both stock piling and low availability. Moreover, M&S is struggling to compete with fast-fashion retailers, which have a closer connection with the “consumer of the future”. We believe C&H’s problems are structural, rather than executional.
- Valuation: our recommendation departs from a DCF valuation method, with a WACC of 7.6% and a terminal growth rate of 1.5%. Our forecast period extends to 2031.
- Key risks to our analysis: (1) Corporate governance shift, (2) Brexit uncertainty, (3) Monetization of properties, (4) Solid progression in the cost cutting plan and (5) Better than expected like-for-likes in C&H.

**Company description**

Founded in 1884 in Leeds, M&S is the UK’s largest retailer, operating in the Clothing & Home (34% UK FY’19 revenues) and Food markets (57% FY’19 UK revenues). Organized in two segments – UK and International – M&S sees c.10% of its revenues and c.23% of its operating profit generated abroad.

**Recommendation:** **SELL**

*Vs Previous Recommendation* -

**Price Target Dec-20:** **190p**

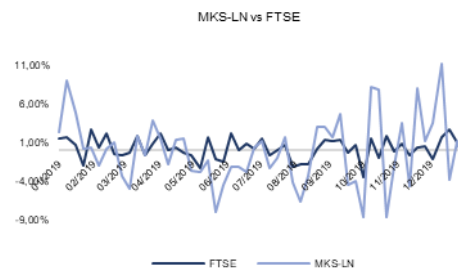
*Vs Previous Price Target* -

**Price (as of 19-Dec-19)** **219p**

Reuters	
Next Reporting Date	20-Mar-20, FY'20
52-week range (£)	161.35-292.86
Market Cap (£mM)	4.26
Outstanding Shares (m)	1,949

Source: Reuters

\*Rounded for presentation purposes



Source: Reuters

(Values in £ millions)	2018a	2019a	2020e
Revenues	10.698	10.377	10.228
EBIT	671	601	541
Net Profit Reported	456	471	421
EPS (in p)	27.8	25.4	21.6
EV/EBIT(x)	16.21	15.62	13.36

Source: Company Filings, ER Analysis

**THIS REPORT WAS PREPARED EXCLUSIVELY FOR ACADEMIC PURPOSES BY BEATRIZ LEITE AND BERNARDO FARIA, MASTER IN FINANCE STUDENTS OF THE NOVA SCHOOL OF BUSINESS AND ECONOMICS. THE REPORT WAS SUPERVISED BY A NOVA SBE FACULTY MEMBER, ACTING IN A MERE ACADEMIC CAPACITY, WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL. (PLEASE REFER TO THE DISCLOSURES AND DISCLAIMERS AT END OF THE DOCUMENT)**

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# Valuation Summary

We conducted a DCF analysis to value M&S. Thus, we forecasted both IS and BS items until 2031 (when the company reaches the steady-state). The valuation uses a 7.6% WACC and 1.5% growth rate in the Bull scenario<sup>1</sup>. We obtained a price target of 190p, which implies 13% downside vs the price as of 19-Dec-19.

Table 1: DCF Valuation and Inputs

Scenarios: M&S Bull and Ocado Base	2018a	2019a	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e	TV
FCF Core	508	726	551	482	406	241	278	259	242	239	246	252	259	266	
FCF Non-Core	297	-214	31	31	47	47	47	47	47	47	47	47	47	47	
<b>Free Cash-Flows</b>	<b>805</b>	<b>512</b>	<b>583</b>	<b>513</b>	<b>454</b>	<b>288</b>	<b>325</b>	<b>306</b>	<b>289</b>	<b>286</b>	<b>293</b>	<b>299</b>	<b>306</b>	<b>314</b>	
<i>FCF growth</i>			14%	-12%	-12%	-36%	13%	-6%	-6%	-1%	2%	2%	2%	2%	
<b>Discounted Free Cash-Flows</b>			<b>627</b>	<b>513</b>	<b>422</b>	<b>249</b>	<b>261</b>	<b>229</b>	<b>200</b>	<b>185</b>	<b>176</b>	<b>167</b>	<b>159</b>	<b>151</b>	<b>1198</b>

g	1.5%
WACC	7.6%

2021 - 2023	1184	30%
2024 - 2027	875	22%
2027-2031	653	17%
TV	1198	31%
<b>EV (as of 01/01/2020)</b>	<b>3909</b>	<b>100%</b>

Pension/Post Retirement Benefit	642
Associates	509
(Net Debt)/Excess Cash	-1280
<b>Total Adjustments</b>	<b>-129</b>

<b>Equity Value as of Dec-2020</b>	<b>3713</b>
# Shares	1949
<b>Price Target Dec-2020</b>	<b>190</b>
Upside/Downside 19/Dec/2019	-13%

Table 2: Sensitivity Analysis for the Bull Scenario  
In green, price higher than current share price

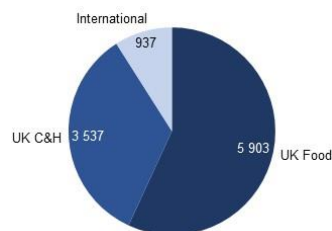
g	WACC					
	6.6%	7.1%	7.6%	8.1%	8.6%	9.1%
0.5%	208	193	181	171	162	154
1.0%	214	198	185	174	165	156
1.5%	222	204	<b>190</b>	178	168	159
2.0%	232	212	195	182	171	161
2.5%	244	220	202	187	175	164

Table 3: Implied Downside Sensitivity for the Bull Scenario  
In yellow, upside higher than -10%

g	WACC					
	6.6%	7.1%	7.6%	8.1%	8.6%	9.1%
0.5%	-5%	-12%	-17%	-22%	-26%	-29%
1.0%	-2%	-9%	-15%	-20%	-25%	-29%
1.5%	1%	-7%	<b>-13%</b>	-19%	-24%	-28%
2.0%	6%	-3%	-11%	-17%	-22%	-26%
2.5%	11%	1%	-8%	-15%	-20%	-25%

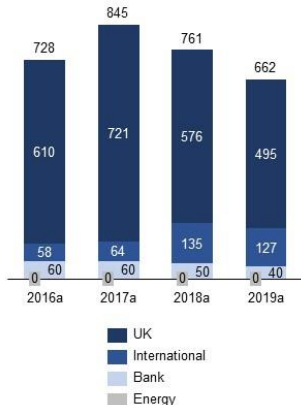
Graph 1. Revenue Split as of FY'19  
In m£

Source: Company Filings



Graph 2. Operating Profit Split  
In m£, reported figures

Source: Company Filings



## Company overview

Marks and Spencer (M&S) is one of the UK's largest retailers, with c.7.6% market share in the UK apparel market as of FY'18 (vs 9.6% in FY'08, source: Euromonitor). Its Food segment is responsible for 57% of FY'19 revenues and c.48% of FY'19 UK gross profit (31% gross margin), while its Clothing and Home segment (C&H) represents 33% of total FY'19 revenues at a 57% gross margin. Having an international footprint, the company operates in two key geographic segments: the UK segment (91% of FY'19 rev) and the International segment (9% of FY'19 rev, 14% operating margin), which incorporates the Republic of Ireland, Europe and Asia, together with other international franchise operations.

### A Shifting Core Strategy

“Don't ask the price, it's a penny” – you could read on a market stall in Leeds, back in 1884. It was then that Michael Marks, a Polish refugee that was later joined by Thomas Spencer, created what is now one of the UK major retailers. Back then, it

<sup>1</sup> Since we are recommending a SELL, we present the most optimistic scenario which still supports our investment decision

**Graph 3. Stock Performance Jan 2014 - Dec 2019**

Source: Company Filings



**Table 4. M&S's cash generation and debt position**

Source: Company Filings, ER Analysis

	2015	2016	2017	2018	2019
Net Debt/EBITDA	1.7x	1.6x	1.5x	1.5x	1.1x
FCF Yield	17%	20%	19%	20%	13%

**Table 5. Peers' Cash generation and debt position, 2018**

Source: Company Filings, ER Analysis

	FCF Yield (%)	NET Debt/EBITDA (x)
Tesco	8.5%	1.1x
Morrisons	6.1%	1.1x
Sainsbury's	16.1%	0.2x
Median UK Food Retail	8.5%	1.1x
Ahold Delhaize	8.9%	2.9x
Carrefour Sa	2.2%	1.7x
Colruyt	1.6%	-0.1x
Casino Guichard	-3.0%	3.6x
Median European Food Retail	1.9%	2.3x
Next Plc	6.4%	1.2x
Kingfisher Plc	-1.0%	-0.1x
Sports Direct In	n/a	1.2x
Jd Sports Fashion	4.4%	-0.8x
Dunelm Group	6.1%	1.0x
B&M European	1.7%	1.9x
Median UK GM Retail	4.4%	1.1x

was unimaginable the ups and downs the once Britain's favourite would face until today.

In 2001, the company hit record-level profit of one billion pounds; however, just three years later, we saw its profits fall to 145 million pounds. Since 2015, the stock price is declining (Graph 3), and it was observed an increasing number of bears on the sell-side, despite the company's strong FCF yield (Tables 4 and 5). Although Brexit's uncertainty can be to blame now (at least partially), it was certainly not the one to blame back in 2015. Operating in two challenging sectors, the company has failed to address the problems it encountered thus far. Margin pressure in Food and an outdated portfolio in Clothing & Home are two of the many factors that can explain M&S's downfall. But most importantly, underneath them, more structural problems can be identified.

After the appointment of Archie Norman as CEO<sup>2</sup>, the company entered an ambitious and much needed turnaround plan. The question is: is it too late?

### The Past

Despite its reputation, M&S has a track record filled with struggles. Focusing solely on this century, one can find episodes of dividend cuts, business relocations and profit warnings. In 2000, the company announced a dividend cut of 40% due to increased competition and bad performance in merchandising (current C&H segment). In 2001, M&S initiated another programme of relocation, selling its International business and firing c.4,000 people. In 2005, M&S issued a profit warning following disappointing Christmas sales. In 2008, it announced another profit warning following disappointing Food performance and the departure of the company's head of Food.

Multiple factors are behind M&S's peaks and valleys. Overall, M&S has lagged competition in several occasions. In the 90s, the company struggled in the C&H segment as it only sold British manufactured products, while fast-retailers were already benefitting from the significant cost savings from producing abroad. In 2001, the company finally started accepting credit cards; before, it tried to incentivise customers to use its Chargecard<sup>3</sup> (source: The Guardian), which obviously was a failure, in a time when the proliferation of bank credit cards was on its peak. In 2010, while competitors were focused on launching initiatives related with the online channel, the CEO Marc Bolland announced a transformation plan to increase sales by redesigning stores and transforming its supply chain, demanding an increase in capital expenditures of £350m – and, even though the

<sup>2</sup> 5-May-2017, stock +5% on the day

<sup>3</sup> M&S's own credit card

transformation plan 2010-2014 was accomplished its goals, its stock performance was not stellar.

While these days the symptoms are different, the patient is still the same; and going through the company’s historical performance leads us to question how much of the past struggles (which look like a *deja-vu* of the current situation) are currently priced in.

### Present and Future

“Another five-year plan, still no great leap forward”, announced The Guardian following the company’s track record of turnaround plans with a 5-year duration.

With the recent “Transformation Update”<sup>4</sup>, the market could finally grasp a sense of the “far reaching change at M&S”. The company is currently in the 2nd of a 5-year turnaround plan, despite the plan for C&H being 18 months behind schedule. Divided in three stages (Figure 1): (1) restoring the basics, (2) shaping the future, and (3) making M&S special, the company expects to be back on track like in the good old days. Cultural transformation is at the epicentre of the change – from the top to the bottom, with new names in a newly structured board committee – but the company is indeed fighting in several fronts.

Overall, cost reduction and increasing supply chain efficiency are two key milestones for M&S. While H1’20<sup>5</sup> witnessed some performance improvements, M&S is still fighting significant structural problems as we elaborate further.

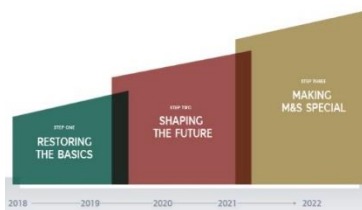
### Shareholder structure

As of June 2019, there are 1,949 million M&S shares outstanding, with each holding one voting right (Table 5). Additionally, the company’s shares trade as American depository receipts, with each receipt representing two shares. M&S shares trade on the London Stock Exchange and the company has recently left the FTSE100 (c. -10% YTD as of Dec-19), after a 35-year stay – since the index inception.

When compared to its peers, M&S was one of the most rotated stocks in this period (Graph 4), reflecting the company’s instability - M&S’s underlying performance deteriorating vs the industry makes it more volatile in comparison to its peers.

In terms of ownership, M&S’s top 1 investor holds a stake of 6.4% (Table 5), which means that the company is not too dependent on one single investor. Additionally,

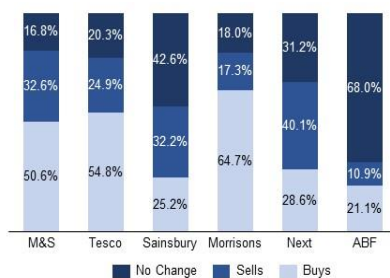
**Figure 1. M&S Transformation Plan Stages**  
Source: Transformation Update, 1-Oct-19



**Table 5. M&S’s Main Shareholders**  
% of total shares outstanding  
Source: Reuters

	% O/S
BlackRock Institutional	6.39
Schroder Investment Management	4.62
Columbia Threadneedle Investments	4.23
Majedie Asset Management	4.16
RWC Partners Limited	3.96
The Vanguard Group, Inc.	3.37
Bank of Nova Scotia	2.63
Jupiter Asset Management	2.48
Wellcome Trust	2.47
Norges Bank Investment Management	2.37

**Graph 4. Rotation vs Peers**  
Source: Reuters



<sup>4</sup> Investor Presentation 1 October 2019

<sup>5</sup> Stands for first-half year results for 2019/2020

being mostly owned by institutional investors, we can expect less volatility than if held by private investors.

Overall, despite the high trading volumes, we think that M&S's shareholder structure is sufficiently stable and diversified and we do not expect it to have significant influence in our valuation.

## UK Food

### Segment Description

The Food segment is responsible for 57% of FY'19 revenues (c.63% UK revenues) and c.48% of FY'19 UK gross profit, implying a 31% gross margin (Graph 5). Its importance has been increasing throughout time, with the company placing greater focus in this segment vs C&H.

Under the Food segment, M&S sells "sustainably sourced, fresh, convenient products of outstanding quality" and its spectrum can be split in 5 key offers: protein deli and dairy, ambient and in-store bakery, means dessert and frozen, hospitality and "Food on the Move". Moreover, Marks & Spencer offers food via two store formats: full-line stores, in which the consumer can have access to both clothing, home wear and food; and Simply Food stores, which are smaller and more convenient stores, focused on Food.

For the last 3 years, M&S has been reporting negative LFLs<sup>6</sup> in the food segment (Graphs 6 and 7) and a declining gross margin (Graph 5). Despite the company operating in a challenging Food business, we argue many of the problems derive from the company's very own business model. Our concerns over M&S's business model vs peers lie on the fact M&S was the biggest market share loser vs UK retail grocers following its declining performance in terms of LFLs (Graphs 6 and 7). Despite some recovery in H1'20 (+0.9% LFL yoy driven by volume) and a positive outlook for Christmas spending, especially after the some tailwinds from the UK election, we defend the positive yoy performance is mostly driven by soft comps after a weak H1'19, with executional problems persisting.

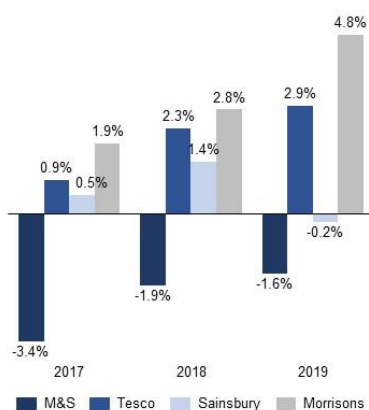
### Stuck in the Middle

M&S is perceived as a premium grocer (Figure 2). Under the current transformation plan, the company is aiming to become a more family-based grocer. To do so, the company is opening new Simply Food Stores, becoming closer to the consumer. With this strategy, M&S expects to place a greater offer in comparison to its peers

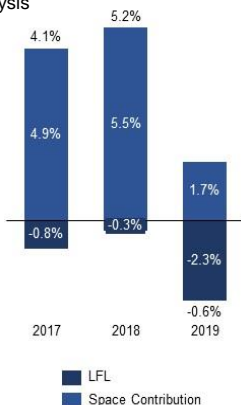
**Graph 5. UK Food Revenues and Gross Margin Evolution**  
In £k  
Source: Company Filings, ER Analysis



**Graph 6. LFLs YoY M&S vs Big 4**  
Source: Companies' Filings, ER Analysis

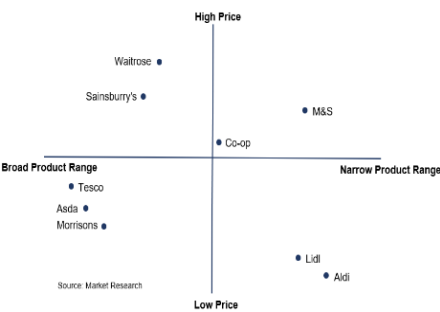


**Graph 7. Revenue Change YoY M&S**  
Source: Company Filings, ER Analysis



<sup>6</sup> Non-IFRS metric commonly used in retail. For M&S, like-for-like stands for the period-on-period change in revenue (excluding VAT) from stores which have been trading and where there has been no significant change (greater than 10%) in footage for at least 52 weeks and online sales

Figure 2. UK Grocery Market Positioning  
Source: ER Analysis



as regular Food stores typically display c.2,000 products. Additionally, the company is investing in price and has entered a joint-venture with Ocado, as we explain further. By appealing to a more family shopper, M&S expects to see consumer's frequency of purchase increasing, thereby becoming weekly rather than a weekend place to shop. While we understand the company's shift, we are afraid M&S ends up "stuck in the middle", not being perceived neither as a premium grocer nor as a food chain. Moreover, becoming a family shopper implies intensified competition from the Big 4<sup>7</sup>, moving away from other grocers such as Co-Op and Waitrose. In a scenario in which the first compete in a significantly lower margin basket, we must raise concerns on M&S's ability to succeed.

### Store Space

As of FY'19, M&S has closed 35 full-line stores; in FY'20, the company intends to close further 85 full-line stores and 25 simply food stores – "some of the low volume, higher cost Simply Food stores, mostly on short leases, will also be progressively relocated or rationalised". With the company in the 2nd of a 5-year turnaround plan, space contribution is expected to be negative in the upcoming years.

### Supply Chain

Despite its food suppliers being mainly located in the UK for the Food segment, on the contrary to what happens in the C&H segment nowadays, Marks & Spencer's inefficient supply chain has led to high levels of waste and low levels of availability. The inefficiency consists of an overweight structure of intermediaries, which is publicly recognized by the company. The restructure of the supply chain constitutes one of its pillars for future growth – because of this, M&S is currently working with Gist and has developed a pilot in its Vanguard major store (which will be rolled-out to another 85 stores in FY'20). We defend benefits will become tangible in the medium-term following the company's increasing confidence in its ability to meet guindace (which was updated from an overall reduction from 0-1% to 1-2%) – despite supply chain costs having increased +3% yoy in H1'20 -, reducing pressure in Gross Margins through a reduction in COGS<sup>8</sup>.

### Price/volume relationship

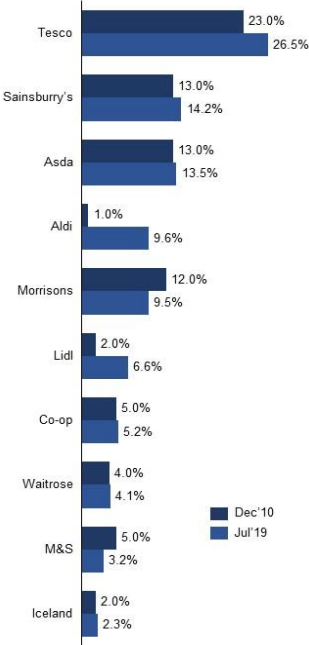
M&S is focusing an important part of its food strategy in adjusting price and volume. There are some items being sold by unadjusted prices, with the company relying heavily in discounting. In 2018, for example, M&S decreased the price of eggs by

<sup>7</sup> Big 4: Tesco, Sainsbury's, Asda and Morrisons.

<sup>8</sup> Stands for Cost of Goods Sold

**Graph 8. UK Food Groceries Market Share Evolution**

Source: Euromonitor



18% and saw sales rise by 43%. As reported by the company in several occasions, the current strategy is to reduce markdown and implement general price reductions, aligning customer perception.

Across Europe in general and the UK in particular, retailers are using demographic information to calculate the maximum price a given customer is willing to pay for a product, both in online and physical stores. The retailers are using the same methods as Airbnb or Uber to analyse big data and forecast the consumer willingness to pay. Thus, it could be profitable to adjust price in some products. However, these adjustments might take significant time and CAPEX<sup>9</sup> investments, that, if the strategy fails, will result in significant losses for the company.

### Challenging Groceries Market in the UK

The UK Groceries market is a highly competitive and consolidated market. With a customer pool of c.67 million people and an overall expected market value of £193.6 billion as of FY'19 (2.4% CAGR 2019-2024, according to IGD), its structure is characterized by the dominance of the Big 4 supermarket chains – Tesco, Sainsbury's, Asda and Morrisons -, holding c.67% of the market share (Graph 8) and the presence of discounters, such as Aldi and Lidl. In this environment, M&S displays greater margins than its peers due to its premium offer and Clothing & Home section but lags behind in terms of revenues also because of such perception (Table 6). The current outlook for the UK groceries market poses key challenges to the industry with (1) the rise of discounters, with the increasingly reliance on other European retailers such as Lidl or Aldi, (2) the increase of M&A activity, and (3) consumers shifting towards the online channel.

**Table 6. M&S EBIT Margins vs Peers**

Source: ER Analysis

	2016	2017	2018	2019
<b>Tesco</b>	2.2%	1.7%	2.3%	2.9%
<b>Morrisons</b>	2.6%	1.9%	2.6%	2.6%
<b>Sainsbury's</b>	3.3%	3.0%	2.6%	2.4%
<b>Median UK Food Retail</b>	<b>2.6%</b>	<b>1.9%</b>	<b>2.6%</b>	<b>2.6%</b>
<b>Ahold Delhaize</b>	3.9%	3.4%	2.5%	3.9%
<b>Carrefour Sa</b>	3.2%	3.2%	3.1%	2.5%
<b>Colruyt</b>	5.6%	5.5%	5.2%	5.4%
<b>Casino Guichard</b>	4.6%	3.1%	2.9%	3.3%
<b>Median European Food Retail</b>	<b>4.2%</b>	<b>3.3%</b>	<b>3.0%</b>	<b>3.6%</b>
<b>M&amp;S</b>	<b>7.4%</b>	<b>7.4%</b>	<b>6.5%</b>	<b>6.3%</b>

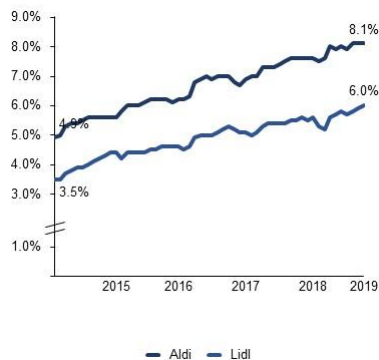
### The Rise of Discounters

As of 2015, Aldi and Lidl held, respectively, 4.9% and 3.5% market share (source: Kantar); as of Sep-19, Aldi has already surpassed Co-operative, being the 5th largest player in the UK groceries market with an 8.1% market share while Lidl has reached a 6% market share (Graph 9). Such trend is not expected to change in the foreseeable future, with IGD estimating discounters alone will contribute to roughly £4 of each £10 increase in market value (source: IGD).

In an industry in which grocery players are particularly hit by higher than expected inflation as families rapidly adapt their consumption patterns during macroeconomic crisis, higher than expected inflation tends to benefit grocery discounters over premium players – placing Aldi and Lidl in a great position over Brexit uncertainty and M&S at the end of the line following its premium

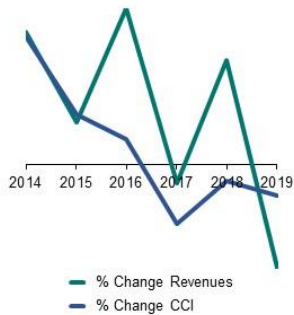
**Graph 9. Market Share Evolution Discounters in the UK**

Source: Euromonitor



<sup>9</sup> Stands for Capital Expenditures

**Graph 10. Correlation Revenues and CCI**  
Source: ER Analysis



perception<sup>10</sup>. Moreover, M&S's high correlation<sup>11</sup> with the UK Consumer Confidence Index (Graph 10) confirms our concerns on the potential impact from Brexit and the consequences on the overall performance of the stock. On top of this, following McKinsey research which concludes that, in the UK, 2,000 items generate 40% of total sales, we are forced to conclude retailers have little operating *manoeuvre* to undercut competition. For M&S, this results in increasing price pressure and challenges concerning an already declining gross margin.

### M&A Activity

Such pressure is further intensified with current M&A trends. For example, Tesco acquired Booker, one of UK's major wholesalers, allowing the company to strengthen their logistics and control costs more efficiently (having more flexibility to reduce prices vs M&S); and Co-Op acquired the wholesaler Nisa, expanding its offer and increasing overall buying power.

**Table 7. Number of Stores per Brand**  
Source: Companies' Websites, ER Analysis

	2017	2018	2019
<b>M&amp;S</b>	<b>979</b>	<b>1,035</b>	<b>1,043</b>
Tesco	3,739	3,952	3,961
Sainsbury's	1,411	1,423	1,428
Morrisons	494	491	494

Moreover, with large chains increasing their number of premium lines, M&S may put a trait for which it is highly rewarded – its premium offer – in jeopardy, especially taking into consideration the easier accessibility of the Big 4 vs M&S, which on average have more stores than M&S (Table 7).

### Online and an Ambitious Partnership

We share KPMG's idea that the importance of the online channel will never reach the same relevance for the food segment as it will for non-food products (source: KPMG's Think Tank); however, we are forced to recognise the importance of the online channel for the British consumer, with our hypothesis being confirmed with IGD estimates of a 7.5% CAGR 2019-2024 for the online segment vs 7% for discounters vs 0.6% supermarkets (Table 8). Indeed, the online channel for food has become increasingly relevant for consumers with 29% of the British consumers purchasing food or groceries online in 2019 (vs 19% in 2011). Sainsbury's, Tesco, Asda, Morrisons, Co-Op and Waitrose already have an online presence. Players such as Amazon and Ocado play preponderant roles in this channel, as we highlight further.

Following shifting consumer patterns and its ambition to become a digital first retailer, M&S has partnered with Ocado, a British online supermarket founded in 2000. With a client pool of 580,000 active customers, Ocado operates under a business model in which the company holds no stores and provides all the

**Table 8. UK Groceries Market CAGR 2019-24 per Channel**  
Source: IGD

Channel	2019-2024 CAGR
<b>Hypermarkets</b>	-0.20%
<b>Supermarkets</b>	0.60%
<b>Convenience</b>	3.10%
<b>Discount</b>	7.00%
<b>Online</b>	7.50%
<b>Other Retailers</b>	-0.80%

<sup>10</sup> We are aware Aldi, Lidl and M&S share relatively similar operational risks in the sense both depend on external suppliers and operate in several geographies other than the UK. The key idea is that in a climate of increasing inflation as would be the one expected in the case of a no-deal Brexit, families' stagnating wages and higher willingness to save would benefit chains which provide to consumers lower prices – as it is the case for Aldi and Lidl. Even in the case of M&S lowering prices, customers' perception would take time to adapt to the new conditions.

<sup>11</sup> 62% R-Squared

deliveries directly from its warehouses. The deal allows M&S to leverage on Ocado’s expertise in retail logistics and distribution, with M&S selling its products via Ocado’s website, thus reducing the execution risk of entering the online channel. We believe the expansion to the online channel is a natural strategic objective for M&S. We understand the reasons behind this partnership, since Ocado already has a functional business in the online business. However, with M&S trading down c.12% on the day of the announcement (vs Ocado +3%)<sup>12</sup> following concerns M&S was overpaying for the JV<sup>13</sup>, we are forced to pose our questions regarding the execution risks of the transaction.

**Terms of the transaction**

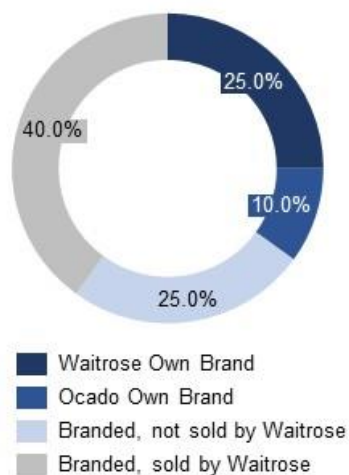
Under the JV agreement, M&S is acquiring a 50% stake of Ocado’s UK Retail business, entering an agreement with the Solutions business via the Ocado Smart Platform. The agreement consists in the payment of a £750m consideration, which includes a deferred consideration of up to £187.5m plus interest, upon the meeting of targets not disclosed. The transaction will become effective in September 2020. To finance the acquisition, M&S proceeded to a 1-to-5 rights issue of £600 million, which was 85.14% subscribed.

**Problem #1: Dependency on Waitrose**

Ocado partners with Waitrose since 2002; under the agreement, Ocado supplies Waitrose’s products as well as Ocado’s own brand. The partnership is ending in September 2020, and, under the conditions of the agreement, the partnership will not be renovated, with M&S replacing Waitrose. The partnership with Waitrose implies exclusivity, with Ocado being tied to a single food retailer. Cutting the tie with Waitrose poses significant risks both on the supply and on the demand sides.

On the supply side, 90% of the products sold via Ocado are Waitrose’s or sourced via Waitrose (Graph 11). M&S’s line does not have the same range as Waitrose’s – M&S totals c.7,000 lines, whereas a typical supermarket would have c.25,000 lines (Tesco has c.30,000 lines and is the #1 in online grocery), so guaranteeing a smooth transition can prove difficult if M&S does not manage to develop its product lines. Moreover, given M&S is seen as a more premium grocer than Waitrose (Graph 11), this could impact significantly the value per basket of the delivered products - especially if the increase in prices is passed to the consumer. If the company is not able to offer discounts or reduce prices, Ocado can suffer a significant increase in logistics costs, despite its lean logistics model.

Graph 11. Ocado’s Portfolio  
Source: Ocado’s Earnings Call, ER Analysis



<sup>12</sup> 27 Feb-2019

<sup>13</sup> For further evidence on Ocado’s valuation, please read Beatriz Leite’s individual report: How to Price-In Ocado?

In its turn, the supply problem leads to a demand problem. There is no evidence of a correlation between Waitrose’s products and Ocado’s sales. However, if the consumer proves to be loyal to Waitrose brand, switching costs in the industry are low enough for the consumer to start buying via waitrose.com, leaving Ocado.

**Problem #2: Dividend Cut**

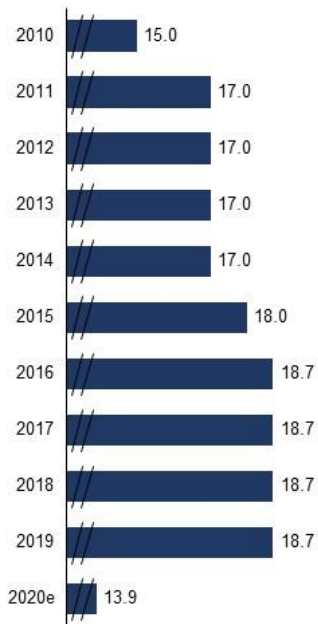
Following the announcement of the JV with Ocado and the rights issue, M&S announced a dividend reset of 40% from 18.7p to 13.p (Graph 12) to what the company considers a “sustainable level”, following its “upcoming debt repayments and pension obligations”. We are forced to express concerns over the signals cutting DPS sends to the market as (1) a stable pay-out ratio in a mature company such as M&S exhibits how financially healthy the company is and (2) given the amount of years still ahead for the current turnaround plan, investors are now less compensated to wait for the upturn of the company. With the company not cutting dividends since 2010, the stock performance on the day of the announcement can be considered reasonable.

**Problem #3: M&A risks and increasing competitiveness**

In 2018, there were rumours Amazon approached John Lewis Partnership regarding a possible acquisition of Waitrose, its grocery chain, but no confirmation was provided by the companies. With the ending of the partnership between Ocado and Waitrose, we see potential for Amazon and Waitrose reinitiating talks. Key catalysts for closing a deal are (1) Waitrose’s physical stores and (2) similarities of the customer base - consumers that are willing to pay more to receive quality groceries at a convenient timing.

In 2015, Amazon launched the Amazon pantry service, which allows Prime members to receive goods within 24 hours not paying a delivery fee, and to have special discounts; later in 2016, the company launched Amazon Fresh in London, which allows members to pay no delivery fees in groceries orders. However, its performance in the UK groceries market is still very modest: Amazon has entered the brick-and-mortar business via the acquisition of Whole Foods. However, due to the existence of only 7 Whole Food’s physical stores in the UK, Amazon’s success is still very limited, as it is mostly restricted to the London area and surroundings. Waitrose’s c.350 stores make it an attractive target for Amazon further develop its presence in the UK grocery market. Additionally, as recognized by David Jinks, head of consumer research at ParcelHero (source: Packaging News), “Waitrose’s generally well-heeled customer base would be a great fit for Amazon”, with Waitrose typical consumer willing to spend extra to receive quality groceries.

Graph 12. Dividend per Share  
In pences  
Source: Company Filings



Given Amazon’s brand name, operational leverage and expertise, such partnership could reveal to be a game changer for M&S, increasing competition in the online channel as well as reducing the return of what we estimate it was an already expensive investment in Ocado<sup>14</sup>.

**Problem #3: Small basket size**

Marks & Spencer’s basket size<sup>15</sup> is c.£20 which contrasts with Tesco’s c.£100 basket size and Ocado’s at c.£100. With Ocado replacing its products to Waitrose, Ocado’s basket size is likely to decrease; as such, we must raise questions on the economics of the deal, especially given the significant costs associated with home delivery (such as fuel consumption, investments in motorbikes, among others).

**Problem #4: Own store cannibalization and gross (not net) synergies**

We also pose questions regarding store cannibalization and the synergies as guided by M&S, but recognize the lack of data at this point that could support our arguments. By incorporating its offer in Ocado’s website, we can observe potential cannibalization of M&S’s current offer. Additionally, the £70m gross synergies<sup>16</sup> (not net) resulting from the JV (1% of M&S’s FY’19 revenues) as guided by M&S might imply further investments, hence having little impact on the company’s P&L.

**Problem #5: Online groceries sales growth stabilization**

Between 2010 and 2016, the percentage of British who purchase groceries online increased (Graph 13). We defend the percentage of online sales for food will never reach apparel’s, and this can lead us to to the conclusion the steady state for online food sales can be relatively close, limiting the upside for M&S - another late-entry for M&S. In a sector where consumer loyalty is important, the consumers might already be tied to other brands, resulting in more obstacles to the company.

Graph 13. Share Individuals Buy Food Online in the UK  
Source: Statista

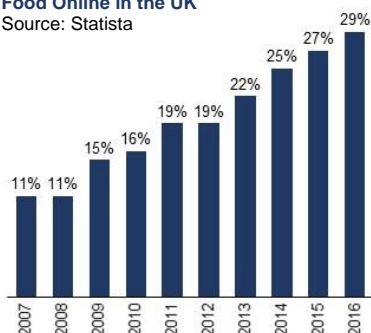


Table 9. UK Delivery Offer  
Source: This Is Money

Supermarket	Min. Order	Delivery Price	Delivery Slot
Ocado	£40	£2.99 - £6.99 or free on Wednesdays	1h
Iceland	£25	£2 - £4 or free over £35	2h
Waitrose	£60	Free	1h
Tesco	£25	£1 - £7 + £4 if spend <£40	1h but 4-hour window
Morrisons	£40	£1.5 - £5	1h
Sainsbury's	£25	£1 - £7 or free delivery with spend over £100 on Mon-Thu after 2pm	1h
Asda	£40	£1 - £6.50	2h
Amazon Pantry	£15	£3.99	1day
Aldi Alcohol	£0	Free over £20 or £2.95 if below	1h

**Competition from Food Delivery Apps**

By partnering with Ocado, M&S will have access to Zoom<sup>17</sup>, a one-hour London, low delivery fees, service. Under this new partnership, “food of M&S (ready meals, quality food) is perfectly suited for this more upmarket convenience shopping”. While we understanding the opening to a new market could imply potential upside, our argument is that such potential is limited given the overall consolidation of the market.

<sup>14</sup> For further evidence on Ocado’s valuation, please read Beatriz Leite’s individual report: How to Price-In Ocado?

<sup>15</sup> Retail metric used to refer to the number of items getting sold in a single purchase

<sup>16</sup> Guidance provided in the Press Release: Bringing the Best Together: Transforming UK online grocery shopping M&S and Ocado announce new Joint Venture, 27-Feb-19

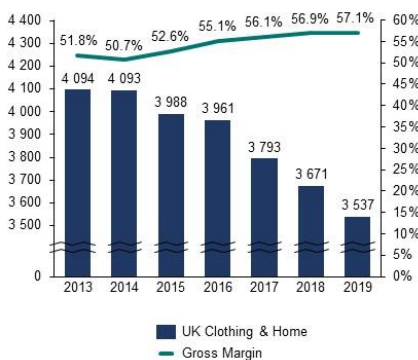
<sup>17</sup> For more information on Zoom, please visit: <https://zoom.ocado.com/>

A combination of factors leads us to conclude M&S will be facing competition from other players besides the traditional food grocers. Being highly rewarded for its premium meal options, its integration in Ocado in general and Zoom in particular will bring new competitors, from different fronts: (1) on one side, online grocers such as Waitrose and Amazon Fresh (Table 9 exhibits other players and its offer); (2) on the other side, food delivery apps (with the industry experiencing double-digital growth (source: Deloitte)) such as Just Eat, Deliveroo and Uber Eats. Following this, despite having access to a larger market, M&S is also exposed to fiercer competition for what could be a relatively small reward.

## UK Clothing & Home

### Segment Overview

**Graph 14. UK C&H Revenues and Gross Margin Evolution**  
In m£  
Source: Company Filings, ER Analysis

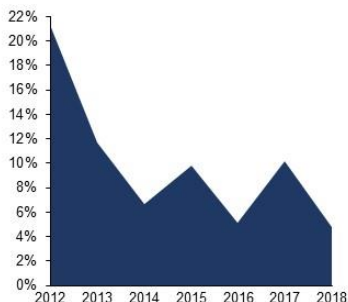


Clothing & Home incorporates Womenswear, Menswear, Lingerie, Kidswear and Home, sold via M&S stores and its online website M&S.com; in total, clothing corresponds to 90% of the segment and generates 37% of UK revenues at c.57% gross margin (Graph 14). The company is widely known for its position in the UK's underwear market and as a jean retailer<sup>18</sup>. Moreover, M&S holds 20% in women knitwear and 25% of kids have acquired a uniform from M&S.

While we recognize the problems in the Food segment are more company-specific than industry-wide, we defend these are executional, rather than structural. Our investment case for the C&H segment does not share the same idea. M&S's offer is outdated and no longer represents a competitive offer in the minds of the millennials; this, combined with an inefficient supply chain, that fails to address those who decide to buy, is the perfect recipe for a declining performance.

### Not that Fast Fashion

**Graph 15. Buzz Score Evolution for M&S**  
Source: YouGov – BrandIndex, via Statista



In 2016, the company's target consumer were women with ages between 40 and 55. Recognizing it failed to target the "customer of the future", jeopardizing its long-term sustainability, M&S is now targeting a "younger family age customer". Under its turnaround plan, the brand has proposed itself to (1) improve fit and size ratios, (2) remove outdated styles and (3) reduce options in 10%, placing greater focus in their top-sellers. Indeed, M&S has finally recognized the need to adjust its collections and increase its popularity (after seeing its Buzz score<sup>19</sup> falling from 10.2 to 4.8 form FY'17 to FY'18 (Graph 15) vs Aldi at 18.7%, Lidl at 13.8% and Morrisons at 8.1%). However, with the current turnaround plan lagging 18 months

<sup>18</sup> Steve Rowe on H1'20 Earnings Call: "I think what we've shown is where we focused probably on our number one categories, we can see growth and we've got record market share in bras at 37.2%, we're number one in jeans at 12% and grew by just over 30% this autumn"

<sup>19</sup> Buzz or Net Sentiment generated across all media (advertising, news, word of mouth), computed by YouGov via a survey

behind as reported in the H1'20 earnings call, the success of such strategy is yet to be proven, especially after reporting -5.5% yoy LFL for C&H in H1'20. Additionally and given consumers preferences towards “faster” fashion retailers, such as Primark and Zara, M&S might be too late to recover in this segment. Indeed, Associated British Food’s Primark has been among the top retail winners in terms of market share as millenials no longer wish to buy clothes where their parents and grandparents did – this is, in places such as M&S.

### First Price, Right Price

Price is considered more important than quality for the UK consumer (source: Kantar, Graph 16) when buying clothes. According to our analysis, M&S is the 2nd cheapest brand in casual menwear and places in line with the median in womenwear (Table 10). Although prices are not the lowest of the analysed peer set, they are relatively aligned with peers – hence, we find it difficult to blame price for its declining performance. Thus, the strategy of adjusting fit and improve look analysed before might make sense to align customer’s perception; however, we believe potential upside is limited due to overall industry’s trends (as we emphasize next).

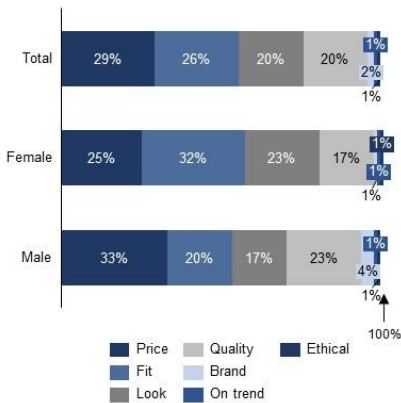
### Store and Space

Marks & Spencer holds a large and outdated store estate. A store closure programme (implying the closure of 85 stores) is already underway as about ¾ of the C&H stores were opened 25 years ago, with c.75% of those existing before WWII. Under this programme, M&S can finally consider to renegotiate leases and rethink potential current cannibalization between stores. With the company’s problems with inventory management (Table 11), a large store space means accumulating inventory that is not consumer’s best picks; which results in the company’s reporting problems with stock piling and further inefficiencies. In specific, M&S’s average store size is c.37,000 vs Next’s 16,000 sq ft, evidencing the brand’s large store size.

As such, one would expect the closure/reduction of store space could lead to an overall cost reduction per store. Following this, we can expect some losses in revenues deriving underperforming stores being shut-down, despite some transfer of sales to current “regular” stores – implying that space contribution is likely to be negative in the upcoming years (as guided by the company).

While M&S has defined an overall store closure/space reduction strategy, we question its contradictions, with M&S opening a 60,000 sq ft store (as a comparison metric, a typical H&M store has c.20,000 sq ft (source: MarketWatch)) in Nottingham Giltbrook Retail Park and its new store in Cornwall – for these stores to prove

**Graph 16. Most important factors when buying fashion items in the UK 2015**  
Source: Kantar, via Statista



**Table 10. Price Comparison vs Selected Peer Group**  
Source: Companies’ Websites, ER Analysis

Casual Wear Men	M&S	Zara	H&M	Next	Primark
White T-shirt	6	5.99	3.99	5	2
Black Jumper	16	19.99	19.99	18	10
Denim Jeans	15	29.99	17.99	14	10
<b>Total</b>	<b>37</b>	<b>55.97</b>	<b>41.97</b>	<b>37</b>	<b>22</b>
Diff vs M&S		51%	13%	0%	-41%
Median	37				
Average	39				

Casual Wear Women	M&S	Zara	H&M	Next	Primark
White T-shirt	4.5	4.99	3.99	5.5	4
Black Cardigan	15	19.99	8.99	13	5.5
Denim Jeans	15	19.99	9.99	14	10
<b>Total</b>	<b>34.5</b>	<b>44.97</b>	<b>22.97</b>	<b>32.5</b>	<b>19.5</b>
Diff vs M&S		30%	-33%	-6%	-43%
Median	33				
Average	31				

**Table 11. Days Sales Inventories: M&S vs Selected Peer Group**  
Source: Company Filings, ER Analysis

	2017	2018	2019
M&S	171	178	178
Debenhams	59	62	62
Next	63	62	64
Asos	110	113	123

successful, a more efficient inventory management and increased availability are vital for these mega stores to bear fruit. Otherwise, building these will be just about bringing more outdated clothing, in a store that provides little valuable consumer experience<sup>20</sup>.

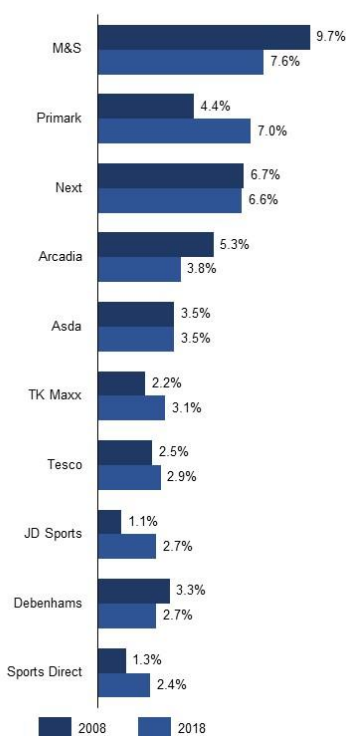
### Inefficient Supply Chain

On one side, M&S uses processes in which products with the same origin and destination are transported via 2 separate shipments. On the other side, the stock is often not adjusted for the store size and customer demand, increasing inventory levels, leading to high days' sales inventory in comparison to its peers, demonstrating the firm's inefficiency (Table 11) - a problem for a seasonal industry such as apparel. As such, M&S simultaneously displays problems concerning stock piling and low availability<sup>21</sup>. Under the current turnaround plan, M&S expects to reduce UK operating costs by 1-2% (Table 12) with the reduction of complexity and working capital; and to expand the Bradford distribution centre and improve capabilities of its Castle Donnington centre. Overall, M&S is trying to centralize its operations, closing warehouses and distribution centres spread around the UK, expanding the most important ones, thus reducing supply chain complexity and increasing efficiency. While we recognize the importance of such programme, our belief is that reshaping its supply chain is necessary not to thrive, but rather to survive, in an industry in which fast-retailers are constantly undercutting the time it takes to bring products from the warehouse to the store.

**Table 12. Company Guidance FY'20**  
Source: Company Filings

UK Food	
Space Contribution	Level
Gross Margin Change	-25bps to +25bps
UK Clothing & Home	
Space Contribution	c.-2
Gross Margin Change	-75bps to -25 bps
Others	
UK Operating Costs (%)	c.-1 to -2
Tax rate (%)	c.23
Capital Expenditure (£m)	300 to 350

**Graph 17. UK Apparel Market**  
Source: Euromonitor



### Fast-Moving UK Apparel Market

M&S holds c.7.6% of market share in the UK Apparel and Footwear Market, being the largest retailer by sales. The company is followed by ABF's Primark (7.0%), Next (6.6%), Arcadia Group (3.8%) and Asda (3.5%). Even though placing first in the non-food retail market sounds encouraging, M&S has been losing market share in the last years (Graph 17). Furthermore, Kantar data also revealed that, on average, M&S sales have decreased -5.7% in the last 12 months ending October vs the average of the sector at -1.8%, emphasizing our argument that M&S is underperforming peers. Regardless, UK fashion retailers have been struggling with (1) shifting consumer preferences, (2) declining performance of High Street<sup>22</sup> stores and (3) increasing importance of kidswear and menswear, with M&S lagging behind its peers.

<sup>20</sup> According to 2018/2019's Annual Report, up to 50% of our store estate has not had major cosmetic refurbishment in the last 10 years – with M&S placing little focus on in-store customer experience

<sup>21</sup> The company has reported the failure to provide clients' favourites in store while simultaneously filling the store with outdated models, only due to its large size

<sup>22</sup> Designation for the concept of the primary business street of towns or cities

### The Online Channel (Again)

The online channel represented 25% of total apparel and footwear sales as of Dec'18 vs 16% Dec'13, respectively (Graph 18). While these trends favour UK pure-online based retailers such as Boohoo and Asos, or Next (which now has 50% of sales sourced via its online channel), traditional retailers that have a relative smaller online presence end up getting lost in the crowd. For M&S, the online market was flat yoy in H1'20<sup>23</sup>, with +8% traffic volume being offset by the costs of paid search; hence, despite its increasing focus on the online channel, the company still fails to materialize this channel in a cost-efficient manner, a common challenge for traditional brick-and-mortars. Additionally, according to a survey from BDO, UK consumers report they are spending more on experiences rather than 'things', which in an industry in which switching costs are close to zero, is reflected in a more elastic demand (and decreased consumer loyalty).

**Graph 18. Clothing, footwear & accessories: share of offline & online sales UK 2010-2020**  
Source: via Statista



**Table 13. Social Media Presence: M&S vs Selected Peer Group**  
'000 followers  
Source: ER Analysis

	Instagram Followers	Facebook Likes
<b>M&amp;S</b>	1,300	5,400
<b>Next</b>	1,400	2,600
<b>Primark</b>	8,000	6,100
<b>Zara</b>	37,200	27,000

### Modest Presence on Social Media

Another aspect that signals the overall hypothesis M&S is outdated in comparison with its peers and the mistakes M&S made in defining its target consumer, lies on the Group's disappointing presence on social media. With the online bringing c. playing an important role for decision making in the fashion industry, M&S's reach is limited (Table 13). The relatively small online presence could signal the limited upside potential from its focus in the online channel.

### Declining performance of High Street Stores

High Street stores are facing difficult times. The previously mentioned shift in consumer preferences has led to c.10% decline in footfall<sup>24</sup> in the last 7 years (source: Springboard). Additionally, brick-and-mortars are struggling with increasing business rates and other operating costs. In comparison, traditional brick-and-mortars pay 2.3% of revenues in business rates vs the 0.6% online retailers (source: Retail Research), impacting negatively its cost base. According to PwC, M&S is the 4th highest payer (among 100 surveyed) of business rates in the UK, which again places the company in a challenging position. A further increase in operating costs for players is expected following Brexit new tariffs and visas and is likely to contribute to (i) rising labour costs and (ii) rising sourcing costs. As such, while we expect the current turnaround plan is significantly reshaping M&S's cost structure<sup>25</sup>, a further deterioration of the High Street can bring more pressure to it.

<sup>23</sup> As of FY'19, Online represented c.18% of total UK C&H revenues

<sup>24</sup> Retail metric used to refer to the number of people entering the store

<sup>25</sup> As evidenced in the H1'20 earnings release with management improving costs guidance from 0-1% decline to 1-2% decline for FY'20 and overall improvement in UK operating costs vs H1'19 at -3.3% yoy

Menswear and sportswear – the new stars

Table 14. M&S's Market Growth vs Market Share In Top Fashion Sections  
Source: Investor Presentation, 19-Oct-19

	Market Growth	Market Share
Suits	-7%	14%
Knitwear	1%	12%
Casual Tops	6%	5%
Activewear	6%	2%

While Euromonitor states menswear and sportswear have been the top performers as of FY'18, BDO forecasts volume growth will remain low, especially due to womenswear. M&S currently holds c.14% market share of the suits category while it only holds 2% of the activewear industry, which is growing at +6% yoy (Table 14). This focus on outdated categories is another evidence M&S has again lagged competition, failing to address customer needs.

International

Operating via owned and franchised stores, the International segment allows M&S to have access to the European, Middle East and Asian markets (and through the online channel, to the US and Australia), holding a total of 444 stores and generating c.10% of the Group's total revenues as of FY'19 (Graph 19) – with owned stores representing c.44% of total International revenues in FY'19 vs c.74% in FY'17.

The company's current international strategy focuses on shifting to a franchisee-dependent model, backing strong partnerships with franchisees, closing underperforming, owned, stores and reducing its selling space (FY'19: 4.9m sq ft vs FY'15: 6.0m sq ft). Simultaneously, the company has been adopting a market pricing strategy, which consists in an overall reduction of prices of c.10% that has yielded positive results as sales were up c.8% in FY'19, following a c.+20% increasing in volumes (Graph 20).

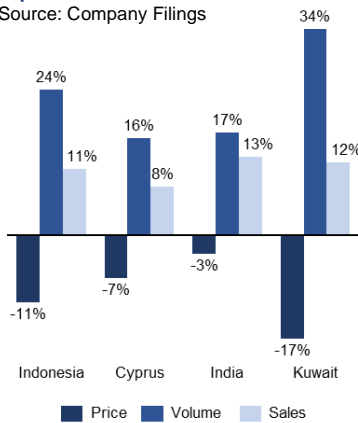
Under the new transformation plan, the company is focused on increasing efficiency in logistics in the International segment. As such, M&S is increasing food stock in EU markets and building a warehouse outside Paris; additionally, amid fears over Brexit, the Group has been preparing itself to flow products from Ireland - this is being done with the objective of increasing fulfilment rates and consequently create more buzz over seasonal launches.

In the International segment, the top performing market is India, where M&S operates since 2001 and partners with Reliance Retail via a JV partnership, and where it plans to expand in the upcoming years. India is becoming increasingly important. Supported on the country's positive macroeconomic outlook – with a middle class expected to expand by c.14% yoy between 2018 and 2022 (source: McKinsey), the country is an interesting opportunity for retailers. The fashion retail market's CAGR 2018-2023 is estimated to be 14.4% and the market is expected to reach \$59.3 billion in 2022 vs the UK market at \$65 billion of 2022 (source: Statista). Greece has also been a key driver of the International segment; however, with a

Graph 19. International Revenues and Operating Margin  
Source: Company Filings



Graph 20. Market Right Pricing Impact FY'19  
Source: Company Filings



fashion retail industry CAGR 2020-2023 at 0.4%, we do not expect major upside for M&S, especially as the company has already a relatively established position in the country, operating since 1990.

While we recognize the good performance in FY'19, the strategy for the International segment is still "all-over-the-place", with revenues fluctuating significantly across the period of analysis (Graph 19). With the company providing little guidance for FY'20 and following the disappointing performance in H1'20 (with revenues down 1.7% yoy), it is still unclear what to expect from the segment.

## M&S Bank

The group has an economic interest in M&S Bank which entitles it to a 50% share of profits of M&S Bank, allocated to the UK's operating profit (4.6% of M&S operating profit FY'19). Under this name, Marks & Spencer provides banking services, via a partnership managed by HSBC. Such financial services include credit cards, savings accounts, mortgages and personal loans, with customers accessing these services online or via in-store branches and bureaux.

The Bank is clearly not part of the core business of M&S, and it has been losing share in the Group operating profit since FY'17 (Graph 21). This partnership was created to improve customer experience, allowing clients to use special credit cards on their purchases, and has not proved to be vital for the business success. Following the lack of guidance, the segment is likely to suffer little transformation in the upcoming years.

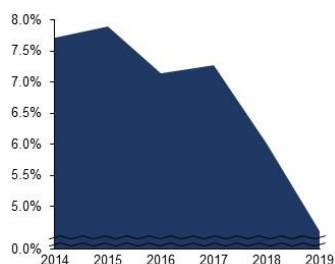
## M&S Energy

Since September 2018, M&S has been partnering with Octopus, after ending the relationship with SSE in the Energy segment; under this agreement, M&S operates a fully renewable energy source provider. We fail to understand the strategic rationale of the partnership; however, given the immaterial impact for current performance (as of FY'19, the unit represented 0.1% of the Group's total operating profit) and the little colour provided by the company regarding its future (especially under its current turnaround plan), we do not expect major turnarounds deriving from this segment.

## Key Catalysts

Many recognize M&S is in an endless turnaround; nonetheless, the existence of catalysts for further share price decreases may seem less evident. We highlight

**Graph 21. Share of M&S Bank Op. Profit in Group Op. Profit**  
Source: Company Filings



three possible catalysts: (1) further deterioration in Clothing & Home, (2) Brexit events and (3) developments following Ocado's integration.

We expect further deterioration in the C&H division and our valuation recognizes the stock is yet to incorporate its deteriorating outlook and market share losses. While it is still unknown what events could drive any further deterioration, stronger than expected performance from competitors can bring more downside to the stock. As such, we encourage investors to monitor closely peers' upcoming earnings releases. Additionally, we recognize the current turnaround plan is not comparable to any other in the past. However, with the objectives for C&H being 18 months behind schedule, and following the disappointing performance of the division in H1'20, we expect the stock to be down post the next earnings release.

On its behalf, Brexit will bring pressure to M&S's topline and bottomline. Regarding topline, and in line with what was previously mentioned, Brexit is likely to bring inflationary pressure (source: PwC), something that would be reflected in deferred consumption. As for bottomline, one would expect that, with constrained borders, less migrants would flow to the UK (migrants represent 18% of the workforce in the UK (source: Migrant Observatory)); on top of this, customs duties over products are expected to increase, pressuring M&S's supply chain. Additionally, such supply chain can see the time associated with the process of bringing products to shelves becoming more long-lasting, following all trade constraints. Unexpected events surrounding Brexit can bring the stock down. While we recognize the overall UK market is likely to underperform following these announcements, the deteriorating performance of the business can lead M&S to show little resilience vs its peers, as it combines structural problems with an unfavourable macroeconomic context.

Upcoming Ocado's earnings releases and developments following the partnership can also be catalysts for the stock. With the integration starting in September 2020, after the ending with Waitrose partnership, we should expect updates soon on the success of the integration of the two services. Even in a situation in which Ocado represents little of M&S's revenues, we expect the market to react significantly to upcoming announcements (on the day the partnership was confirmed M&S's stock was down c.12%).

Overall, we believe risks are set to the downside rather than to the upside in the upcoming 12 months.

## Risks to the Upside

### Corporate Governance Shift

**Table 15. Board Composition**  
Source: Company Website

<b>Chairman</b>	Archie Norman
<b>CEO</b>	Steve Rowe
<b>CFO</b>	Humphrey Singer
<b>Head of Food</b>	Richard Price
<b>Head of C&amp;H</b>	Stuart Machin

Mr. Rowe has admitted in the past M&S's culture is "siloed, slow and hierarchical" with bureaucracy leading to inefficiencies and dragging the company down. However, we are aware M&S is undergoing a serious cultural transformation with Mr. Rowe building an elite team (Table 15).

Despite the absence of a new appointed CFO after the resignation of Mr. Humphrey Singer 3-days after M&S dropping the FTSE 100 (M&S was one of the founding members of the index), the new Heads of C&H and Food have a strong reputation in the industry. After the resignation of Jill McDonald, C&H managing director, M&S announced he would be succeeded by Richard Price former Tesco F&F director; and Stuart Machin, ex-Sainsbury's, is leading the Food division. With all the fresh blood, we believe this transformation plan might not look like any other in the past, yielding positive results for the company.

### Brexit Uncertainty

As reported by the company, we understand M&S is preparing for a no-deal scenario. Regardless, following the stock's correlation with the UK Consumer Confidence, we expect it to reflect the outcomes of the Leave decision. Specifically, on 18-Oct-19, after a week of positive newsflow when it concerns to Brexit, a deal between the UK and EU was announced and the stock was up +5% from the 9th to the 18th. As such, we are aware the stock has performed positively greatly due to the more favourable macroeconomic context. Such fact is not odd; what is questionable is the stock's performance after the announcement of a new law to ensure the Brexit transition phase is not extended on 20-Dec-2019 – with the stock down c.-1.2%. Our concerns lie on the fact the market might be overestimating announcements that are positive for the economy, and underestimating the ones that are not, distorting the stock's price in the sense it does not represent the fundamental value of the company. While we understand the limitations of the argument, as we are ignoring many other variables, we do not think this factor can be left out when analysing potential risks.

### Monetization of Properties

The closure of stores can bring opportunities to M&S. While it is not certain the outcome for the closed stores, there is potential for the company to monetize such properties, by selling or renting them, especially after the appointment of a new Property Development Director in FY'19 with the objective to "unlock value" from the portfolio.

### Solid Progression in the Cost-Cutting Programme

Management has reported £75m cost savings in H1'20 and raised cost savings target in FY'20 from 0-1% of operating costs to 1-2% (Table 12), expressing obvious confidence in the success of its transformation plan. The company has attributed cost savings to changes in the scale of its offices and announced it expects further cost savings in H2'20 with the development of the store closure programme. Management's confidence and the reported cost savings can have a material impact in the stock's performance. Despite the strong results and as expressed before, we expect top-line deterioration will more than offset the targeted cost savings.

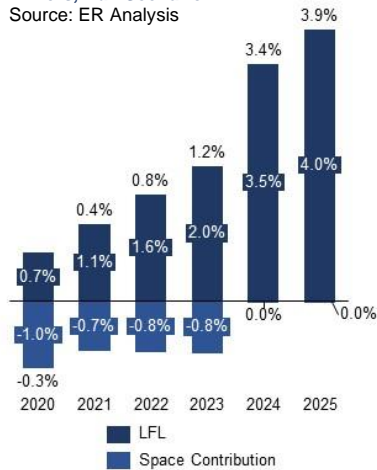
### Better than expected LFLs in C&H

As of HY'20 results, the company reported full price and planned promotional sales growth of +2.7% for October. If space were to represent roughly c.-2% of growth, this would imply +4-5% LfL growth for the month. If this trend were to be maintained throughout the rest of the half-year, our estimates would suffer significant changes. However, despite these encouraging numbers, the positive performance is relatively in line with the industry growth for the same month, which presents the fastest annual growth rate since April (source: Kantar, Table 16).

Table 16. UK Fashion Market Sales Change YoY  
Source: Kantar

	Oct/18	Nov/18	Dec/18	Jan/19	Feb/19	Mar/19	Apr/19	May/19	Jun/19	Jul/19	Aug/19	Sep/19	Oct/19
<b>UK Market</b>	-1.5%	-1.9%	-1.3%	-0.7%	-0.3%	1.1%	-0.8%	-1.8%	-4.0%	-3.5%	-2.4%	-3.0%	-1.7%
<b>M&amp;S</b>	-2.4%	-4.8%	-5.0%	-7.0%	-5.3%	-4.3%	-3.0%	-5.4%	-8.1%	-8.2%	-5.6%	-9.7%	-3.7%
<b>Next</b>	-1.7%	-1.6%	-1.5%	-1.4%	-0.4%	1.2%	0.5%	0.4%	-2.0%	-0.6%	1.0%	-0.3%	-0.4%
<b>Primark</b>	2.0%	2.6%	1.7%	2.2%	2.7%	7.4%	5.4%	6.4%	0.8%	0.7%	3.5%	2.9%	2.8%
<b>Debenhams</b>	-1.8%	-0.9%	-1.3%	-2.6%	-2.6%	-2.1%	-6.6%	-11.0%	-15.5%	-14.4%	-13.6%	-14.0%	-16.1%
<b>Zara</b>	-9.3%	-7.5%	-2.3%	6.6%	2.3%	-1.1%	-6.7%	-5.3%	4.6%	7.2%	4.3%	2.0%	3.7%
<b>H&amp;M</b>	-8.5%	-6.4%	-2.5%	3.2%	1.9%	11.8%	12.8%	14.1%	8.0%	8.5%	6.3%	10.0%	6.5%
<b>Arcadia Group</b>	-10.4%	-15.3%	-16.6%	-14.5%	-10.9%	-5.1%	-11.3%	-14.5%	-13.6%	-14.1%	-18.8%	-16.3%	-15.9%

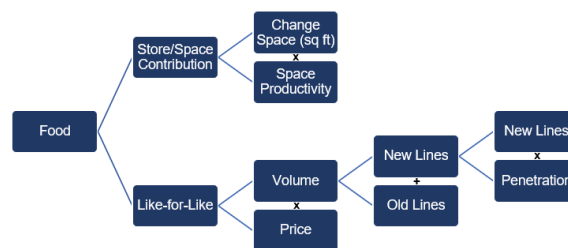
Graph 22. UK Food Revenue Drivers, Bull Scenario  
Source: ER Analysis



## Business Model<sup>26</sup>

### Food Revenues

Food revenues are estimated departing from two key drivers: (1) store/space contribution and (2) like-for-like (Graph 22).



<sup>26</sup> We present performance for the three scenarios outlines, as explained below. If not clear, please consider we are referring to the Bull Scenario

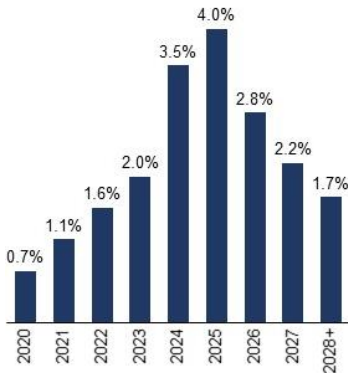
**Store/space contribution**

To assess the impact of space in food revenues, the number of stores and its size were estimated. The company is guiding for the net closure of 15 stores (i.e., total number of stores after the opening of new larger Simply Food stores formats and the closure of c.85 full-line stores) for FY'20. Assuming, on average, store size is declining following the company's current store closure programme until 2023, it is possible to obtain an average store size of c.9,000 sq ft for mixed used stores and 7,000 for simply food stores. Assuming the productivity from space<sup>27</sup> is the same as in the previous year, we are able to obtain the impact from changes in space. Given the overall reduction in space until FY'23, we forecast negative space contribution until FY23, stabilizing to zero from then onwards.

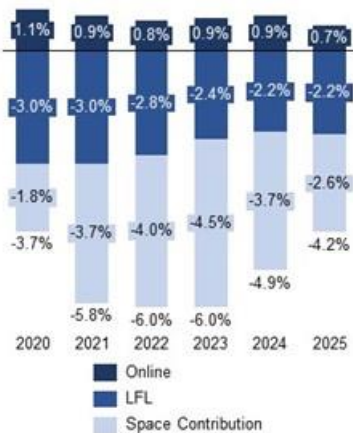
**Like-for-Like**

To assess the performance of retained stores, we consider volume and price. Assuming price is growing roughly at inflation rate, volume will be driving revenues. To obtain the volume contribution, we estimate an average volume contribution for current lines based on historical data. As for new lines, we assume the company will be increasing the number of lines each year, reaching c.8,100 lines, placing M&S closer to the remaining food chains. Such assumption is aligned with the company's strategy of (1) increasing its offer following its integration in Ocado and (2) becoming closer to an everyday place to shop. As it would not be reasonable to assume all lines are materialized into sales, we consider a penetration rate, variable in the analysed period (Graph 23).

Graph 23. UK Food LFL Evolution, Bull Scenario



Graph 24. UK C&H Change YoY per Driver, Bull Scenario  
Source: ER Analysis

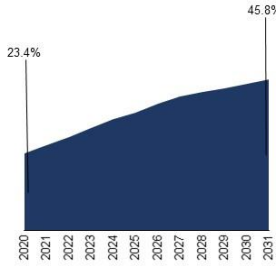


**Clothing & Home Revenues**

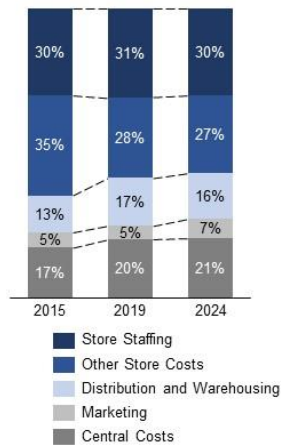
In the case of Marks & Spencer, space contribution and like-for-like are the key drivers to understand C&H's revenues (Graph 24).



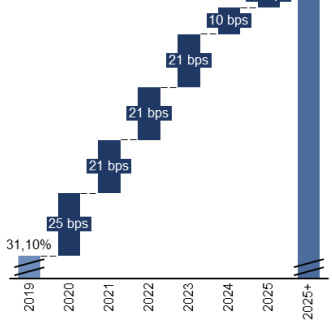
**Graph 25. Share of Online in UK C&H, Bull Scenario**  
Source: ER Analysis



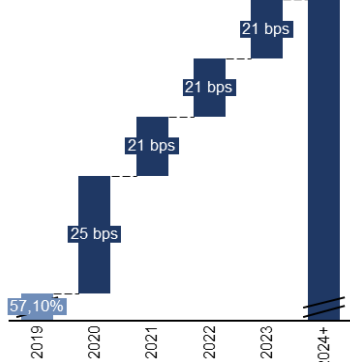
**Graph 26. Share of Online in UK C&H, Bull Scenario**  
Source: ER Analysis



**Graph 27. UK Food Gross Margin Evolution, Bull Scenario**  
Source: ER Analysis



**Graph 28. UK C&H Gross Margin Evolution, Bull Scenario**  
Source: ER Analysis



**Space Contribution**

We have identified two types of stores: underperforming and regular ones. As reported by the company, M&S is struggling with oversized stores and small assortment, with management focusing on (1) reducing the number of stores and (2) reducing selling space. For these reasons and following the recent H1'20 earnings call, our Bull case assumes M&S will be closing 110 stores in the upcoming years – until 2027. At the same time, we forecast a decline in the average selling space for C&H stores, which is aligned with the company's guidance for 2019/2020. The overall reduction in size takes into consideration M&S's focus on top-sellers, reducing the already small portfolio of products, hence demanding less store size. For each of the types of stores, an average sales density was determined, with underperforming stores being 45% less productive than regular stores in FY'19. With these variables, space contribution is simply computed as the number of closed stores times the average sales density.

**Like-for-Like**

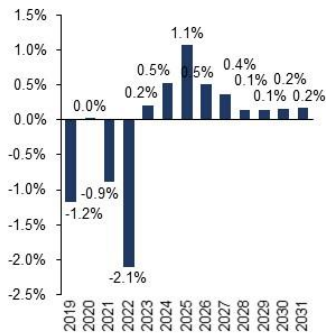
Like-for-like is estimated based on the number of remaining stores and densities. On top of this, we add the impact of online, which stabilizes in 2027 when it represents c.45% of C&H sales (Graph 26), with the company reaching its 2023's objective to have 1/3 of its C&H sales generated online. Still, it would be naïve not to account for synergies from the stores closure - M&S recognizes the proximity between stores; hence, we assume regular stores will recapture of 20% of the sales closing stores' revenues, in line with management's guidance on the last earnings call.

**International, Costs and Margins**

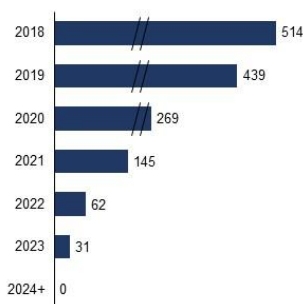
International revenues were modelled taking into consideration the expected growth rates for the main geographies. Additionally, our Bull case assumes the company meets the top of the guidance in terms of gross margin improvements for FY'20, both in Food and Clothing & Home. We expect gross margin improvements to stagnate at the end of the turnaround plan for C&H, while we model 30% accrued synergies from the Ocado transaction to the Food segment from 2021 to 2023 (recall gross synergies of the transaction total £70mn) (Graphs 27 and 28).

In what concerns operating costs, M&S distinguishes five key operating costs for the UK: store staffing, other store costs, distribution and warehousing and central costs (Graph 29). In H1'20, M&S has presented significant confidence on its ability to reduce costs, updating guidance for FY'20 from 0-1% cost reduction to 1-2% - because of this, and given the company reported -3.3% UK operating costs yoy,

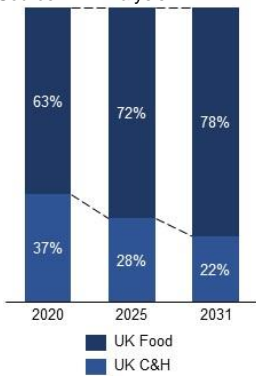
**Graph 29. UK Op. Costs Change YoY**  
Source: ER Analysis



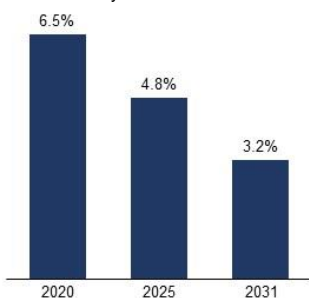
**Graph 30. Group's Adjustments**  
Source: ER Analysis



**Graph 31. UK Sales Mix, Bull Scenario**  
Source: ER Analysis



**Graph 32. Group's Operating Margin Evolution, Bull Scenario**  
Source: ER Analysis



despite the introduction of IFRS 16, we are confident the company will be able to reduce pressure in its cost base. As such, we think the current cost cutting measures are bearing fruit and our modelling assumptions estimate an overall reduction of UK operating costs between 2020 and 2022, with the most relevant decrease in FY'21; afterwards, costs are growing at an average growth rate of 0.4% until 2031 driven mostly by higher maintenance costs associated to sales increases.

Additionally, we model improvements in terms of operating margins for the International segment for the upcoming 5 years following company's store closure and reshifting towards a smaller and higher sales density stores. We also model adjustments<sup>28</sup> related with the strategic turnaround plan, that are decreasing during the years of the plan (Graph 30).

Our assumptions emphasize we are confident on the company's ability to become more efficient in terms of bottom line; our concerns lie on the company's ability to fight topline adversities and the modelling of our investment case reflects this belief. Regardless, while we estimate the company finely balances its cost structure, its increasing dependency on the Food segment results in an overall margin deterioration – Food is margin dilutive (Graphs 31 and 32). In 2031, overall operating margin is at a c.3% level, in line with other Food peers.

## Valuation

### EV/Equity Bridge

M&S provides its employees access to the UK Defined Pension Scheme. The amount of surplus recognized as of FY'21 - which totals £632m - was added from the enterprise value to get a fairer valuation.

Furthermore, Ocado<sup>29</sup> must be taken into consideration when computing the equity value. Since M&S only acquired the Retail division of Ocado, it was difficult to estimate how much of the market value would indeed represent this segment. Hence, an individual valuation of the Retail business was conducted and it was the amount of the Equity Value obtained that was considered for the stake in Associates; Ocado's equity value was added to the Enterprise Value as the partnership could be liquidated to repay debt, hence has a similar treatment to cash.

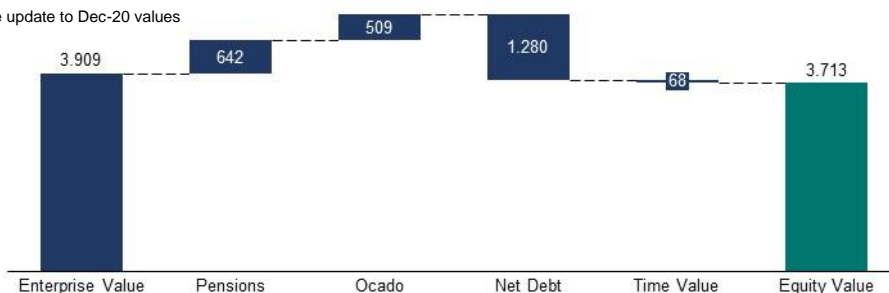
<sup>28</sup> Adjustments related with Strategic Programmes, M&S Bank's credit impairments, among others  
<sup>29</sup> Investment will be accounted as an associate

No other adjustments were considered as no other relevant balance or off-balance sheet items were identified (Figure 3).

Figure 3. EV – Equity Bridge

Source: ER Analysis

Since M&S reports in March, time value corresponds in the update to Dec-20 values



### WACC

Table 17. WACC Calculation

Source: ER Analysis

	UK	International	Total
Core Business Revenues	9441	937	10377
Beta Unlevered	0.68	0.54	0.67
Beta Levered	1.19	0.91	1.16
Market Return	9.18%	17.34%	9.91%
Risk-Free	0.50%	1.96%	0.63%
Cost of Equity	10.83%	15.98%	11.29%
Cost of Debt	1.79%	1.79%	1.79%
Tax Rate	19%	30%	30%
D/(D+E)	38%	38%	38%
E/(D+E)	62%	62%	62%
WACC	7.29%	10.43%	7.57%

Since M&S has its operational activity divided into international and domestic markets, 2 different WACCs were estimated. The rationale was the same for both, and the international peers were selected considering the geographical areas M&S has, or intends to have in the future, more operations. In international WACC, peers from Germany, France and India were selected, which can fairly represent the diversity of countries where M&S has its operations. Final WACC was calculated using a weighted average of the international and domestic WACCs, considering the core business revenues (Table 17).

Table 18. Bu Calculation

Source: ER Analysis

UK				
in billions	Market Cap	An. Average Return	Raw Beta	Bu
MARKS AND SPENCER	3338	-12.38%	0.88	0.43
TESCO PLC	23005	4.75%	1.15	0.63
NEXT PLC	793	1.96%	0.90	-0.09
OCADO GROUP PLC	9290	38.98%	0.97	-0.97
ASOS PLC	2018	8.76%	1.47	1.32
B&M EUROPEAN VALUE RETAIL	3868	9.67%	0.77	0.52
WH SMITH PLC	2699	12.50%	0.63	-0.39
				<b>0.54</b>
International				
in billions	Market Cap	An. Average Return	Raw Beta	Bu
India				
TRENT	1946	33.62%	0.80	-1.07
TITAN COMPANY	10706	29.50%	0.83	0.80
JLA INFRAVILLE SHOPPERS LTD	678	55.86%	2.28	2.18
Rest of Europe				
CARREFOUR	10573	-7.16%	0.88	0.30
CASINO GUICHARD	4178	-8.41%	0.98	0.38
METRO WHOLESALE	4570	0.62%	0.39	0.19
				<b>0.54</b>

### Cost of equity

The cost of equity was estimated considering 6 M&S's peers, both for domestic and international markets. These were selected based on the raw beta, since a comparable with a raw beta completely different from M&S would not be a good estimator for our forecast. Raw betas were calculated based on the last 5 years of monthly data for closing prices of each stock. The unlevered beta of the industry was estimated by the weighted average of each stock's beta by market capitalization (Table 18). In this formula, we used the UK 10Y Government Bond as a proxy for risk-free and the annualized average return of the peers as market return.

Table 19. Cost of Debt

Source: ER Analysis

EBIT 2019	601
Current interest expenses	112
Current LT gov. bond rate	0.50%
Country risk premium	0.69%
Risk free rate	-0.19%
Interest coverage ratio	5.39
Estimated Bond Rating	A2/A
Estimated Company Default Spread	1.4%
Estimated County Default Spread	0.60%
Estimated Cost of Debt	1.8%
Book Value of Straight Debt	2,113
Average Maturity	14.19
Market Value of Debt	3,031

### Cost of Debt

We reached an estimated cost of debt of 1.79%<sup>30</sup> (Table 19). The estimated bond rating was A2, given the company's FY'19 EBIT and interest expenses.

Given it is not expected that the interest coverage ratio significantly changes, we estimate the bond's rating will remain constant, and therefore the cost of debt.

<sup>30</sup> Using the formula Cost of Debt = Risk-free + Default spread + Country Default Spread

**Table 20. Capital Structure**  
Source: ER Analysis

in billions	Market Cap	D/(D+E)
MARKS AND SPENCER GROUP	3,338	55.9%
TESCO PLC	23,005	50.2%
NEXT PLC	793	92.0%
OCADO GROUP PLC	9,290	0.0%
ASOS PLC	2,018	12.4%
B&M EUROPEAN VALUE RETAIL S.A.	3,868	36.6%
WH SMITH PLC	2,699	43.1%
<b>Weighted Average</b>		<b>37.7%</b>

### Capital Structure

Capital structure was forecasted based on the domestic peers. For reasons of consistency, international peers were not considered since some of them, namely the emerging markets ones, are in a completely different steady-state position from M&S, and the domestic operational activity of the company is still very concentrated in the UK. Indeed, the majority of the international peers have completely different capital structures compared to M&S (Table 20). For consistency, the same peers were used to estimate the future capital structure of the company. Thus, it is assumed that M&S's future capital structure converges to the industry average. This ratio was calculated by a weighted average of the capital structure and company market capitalization.

## Fine Tuning Our Valuation

Understanding the risks behind a SELL recommendation, we conducted both a scenario analysis and a multiples valuation, allowing us to triangulate the TP as of Dec-2020 for M&S.

### Scenario Analysis

We have built three scenarios, which besides covering the different topics guided by the company, incorporates our assumptions on the overall performance of the company (Attachment 1).

#### General Assumptions

Despite the several specific assumptions to the several scenarios, there are underlying conceptions to all the three scenarios.

- The strategic programme leads to an overall revamp of food revenues. In the first years, modest growth is driven by negative space contribution following the closure of 15 stores (net value) as of FY'23;
- Positive LFL with drivers changing throughout the years: initially, following the reduction in discounting and an overall decrease in prices, prices are not expected to contribute until FY'23 and c.0.5% from 2023 onwards;
- C&H revenues decline during the transformation plan mostly driven by the fact that M&S is not able to meet fashion standards vs fast-retailer, materializing in negative space contribution following store closures;
- Sales recapture from closure and resizing slowing from c.20% to 0% in 2031 as we expect decreasing synergies from store closures;
- Online key driver until 2025 for C&H.

**Specifics**

The scenario analysis covers topics from each segment’s revenues to gross margins and balance sheet (i.e., inventories, CAPEX, etc) and aligns the overall growth rate of the company with the terminal FCF average from 2028 to 2031 (i.e., for the Base and Bear scenarios, growth rate at +0% and in the Bull case, at 1.5%). The results from our analysis as well as the drivers are highlighted in Attachment 1. Overall, in the bull scenario, TP as of Dec-20 could reach as high as 190, implying 13% downside vs the price at 19 December 2019 or as low as 106, implying 52% downside vs current price (Table 21, Attachment 1).

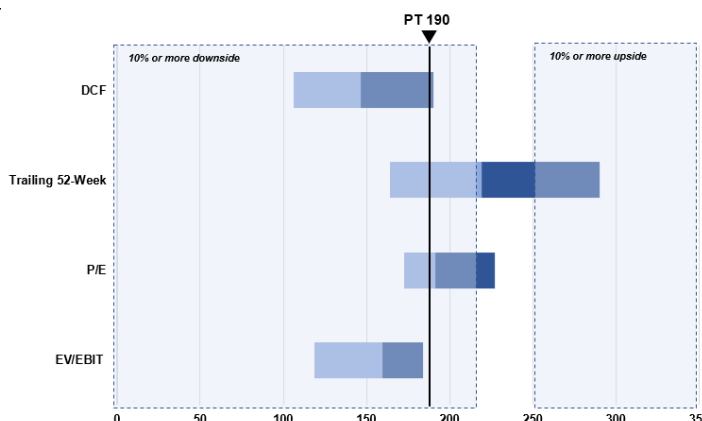
**Table 21. Price Targets according to outlined scenarios**  
Source: ER Analysis

	Bull	Base	Bear
PT Dec-20	190	147	106
Implied Downside as of 19-Dec-19	-13%	-33%	-52%

**Multiples Valuation**

We have identified 3 key comparable groups: (1) UK Food Retailers, in which we include Tesco, Morrison and Sainsbury, (2) European Food Retailers, which comprise Ahold Delhaize, Carrefour, Colruyt and Casino Guichard, which are peers with an international presence and that display similar gross margins to M&S and (3) UK General Merchandising Retailers, which include Next, Kingfisher, Sports Direct, JD Sports, Dunelm Group and B&M. Looking at 1-year forward multiples<sup>31</sup>, our analysis implies Marks & Spencer trades at 0.4x EV/Revenues, 7.2x EV/EBIT and 9.2x P/E. The conclusions of the valuation are presented in Figure 4, which emphasized our SELL recommendation, with M&S showing more potential downside than upside when incorporating the two valuation methods.

**Figure 4. Football Field Valuation**  
Source: ER Ar



<sup>31</sup> This is, using Bloomberg “EEO” function to obtain CSS and compute implied multiples for each peer group

**Small Note On Valuation**

While attempting to model the different DCF lines, we tried to identify correlations between M&S and its peers and between M&S and the overall industry data. The analysis did not provide much colour on the future prospects for M&S as, despite being exposed to industry-wide problems, M&S problems are company-specific, allowing us to reinstate our SELL recommendation. Additionally, our model does not account for the impact of IFRS 16<sup>32</sup> as this accounting norm has no implications on the valuation of the business – the accounting treatment did not change the cash generation potential of the company.

**Final Remarks On The Equity Story**

Despite its efforts to become a more updated retailer and to be top-of-mind for the British consumer, M&S is deeply struggling with lagging behind competition, especially in the Clothing & Home segment. While we agree the company will be able to reset its operating cost base (assuming no greater challenges from Brexit), we do not expect a major turnaround in the company’s topline. Food represents limited upside while Clothing & Home is deteriorating year after year, with no signs for possible recovery. As such, and given the lack of potential upside drivers for the stock, we are forced to present a SELL recommendation.

**Attachments**

Attachment 1. Scenarios  
Source: ER Analysis

	Bull	Base	Bear
<b>Food Revenues</b>	Until 2031, company launches c. 2000 new lines following new positioning and Ocado. Company is expected to create 50 new lines per year reaching an overall penetration of 80%	Until 2031, company launches c. 1300 new lines following new positioning and Ocado. Overall penetration of new lines at 60% in the steady-state with 25 new launches from 2027 onwards	Until 2031, company launches c. 1200 new lines following new positioning and Ocado. Overall penetration of new lines at 60% with 25 new launches per year
<b>C&amp;H Revenues</b>	M&S is well succeed in its plan to close 85 stores, ending up closing 110 stores until 2027. Regular stores exhibit increasing sales density. Underperforming stores with a 1.5% yoy decrease in sales densities	M&S is well succeed in its plan to close 85 stores, ending up closing 110 stores until 2027. Regular stores exhibit sales density growing at 0.5% yoy. Underperforming stores with a 2.5% yoy decrease in sales densities	M&S closes 84 stores. Regular stores exhibit stable sales density. Underperforming stores with an average 3.0% yoy decrease in sales densities
<b>International Revenues</b>	2.5% yoy change until 2024, 1% thereafter	1% yoy change	0% yoy change
<b>Gross Margin Food</b>	Significant improvements in gross margin. Until 2023 and following the incorporation of Ocado, 30% of the gross synergies expected to accrue to the gross margin; between 2024 and 2025, 15% of Ocado’s synergies still accrue to gross margin. Gross margin stabilizes at 32.2% in 2025	15% of Ocado’s synergies accrue to gross margin with gross margin in FY22 stabilizing at 31.3% in 2023	Gross margin reaches lower-end of guidance at -25 bps and is stable from FY’20 onwards at
<b>Gross Margin C&amp;H</b>	Gross margin performs better than guidance, with an increase of +25 bps; +12.5 bps of margin increase until 2023, with margin stabilizing at 57.8%	Stable at FY’19 levels, with margin at 57.1%	M&S reaches bottom guidance in FY20. No synergies accrued from Ocado deal. Stabilization margin from 2021 onwards at 56.5%
<b>International Op. Margin</b>	Increases +15 bps until 2025; stable from then onwards at 13.9%	Stable at FY’19 levels, with margin at 13.6%	Stable at FY’19 levels, with margin at 13.6%
<b>Inventory/Receivables/Payables</b>	Increasing efficiency in inventory from year 2020 onwards following reduction in store and greater availability translating into lower holding period; improvements in relationship with suppliers increasing time to pay. Capex as a % of sales stabilizing at c.2% in line with industry average with investment in PPE at c.3% of sales	No change in efficiency in inventory; improvements in relationship w/ suppliers increasing time to pay. Depreciation as a % of sales decreasing following closure of stores; capex as a % of sales stabilizing at c.3%. Capex as a % of sales stabilizing at 3.3% with investment in PPE at c.2% of sales	Decrease in efficiency in terms of payables, inventories and receivables reflected in increasing holding period and decreasing collection period. Capex as a % of sales stabilizing at 3.3% with investment in PPE at c.2% of sales

<sup>32</sup> In accordance with IFRS 16, the Group will start recognising an expense in respect of leases of low-value items on a straight-line basis over the life of the lease. For all other leases, (with the exception of short-term leases less than 12 months which fall outside the scope of IFRS 16), the Group will recognising a right-of-use asset and corresponding liability at the date at which the leased asset is made available for use by the group.

## Attachment 2. Balance Sheet

Source: ER Analysis

## Core

GBP in millions	2019a	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Operating Cash	156	102	101	100	99	100	101	102	102	103	104	104	105
Inventories	700	729	667	640	634	638	642	644	646	646	650	653	657
Trade Receivables	523	504	497	491	487	491	498	513	516	519	522	525	529
Tax Receivables	0	0	0	0	0	0	0	0	0	0	0	0	0
PP&E	4,029	3,769	3,618	3,560	3,590	3,616	3,661	3,694	3,716	3,729	3,733	3,727	3,714
Intangibles	420	376	357	352	358	373	385	394	400	406	410	414	417
Goodwill & Brands	80	80	80	80	80	80	80	80	80	80	80	80	80
Trade Payables & Other Payables	(1,784)	(1,759)	(1,734)	(1,713)	(1,699)	(1,716)	(1,741)	(1,771)	(1,783)	(1,789)	(1,800)	(1,811)	(1,822)
Provisions	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)	(399)
Other Taxes Payables	(26)	(26)	(34)	(29)	(30)	(31)	(30)	(30)	(30)	(30)	(30)	(30)	(30)
Deferred Tax Assets/Liabilities	(218)	(239)	(215)	(212)	(182)	(172)	(166)	(153)	(146)	(144)	(141)	(140)	(138)
<b>Core Business Invested Capital</b>	<b>3,481</b>	<b>3,138</b>	<b>2,938</b>	<b>2,870</b>	<b>2,938</b>	<b>2,981</b>	<b>3,032</b>	<b>3,073</b>	<b>3,104</b>	<b>3,121</b>	<b>3,128</b>	<b>3,125</b>	<b>3,113</b>

## Non-Core

GBP in millions	2019a	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Investments	45	45	45	45	45	45	45	45	45	45	45	45	45
Investments in Affiliates	4	4	4	4	4	4	4	4	4	4	4	4	4
Derivative Assets/(Liabilities)	172	172	172	172	172	172	172	172	172	172	172	172	172
<b>Non-Core Business Invested Capital</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>	<b>221</b>

<b>Net Operating Assets</b>	<b>3,702</b>	<b>3,359</b>	<b>3,159</b>	<b>3,091</b>	<b>3,159</b>	<b>3,203</b>	<b>3,253</b>	<b>3,295</b>	<b>3,325</b>	<b>3,343</b>	<b>3,350</b>	<b>3,346</b>	<b>3,334</b>
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## Financials

GBP in millions	2019a	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Financial Liabilities	(1,793)	(1,445)	(1,280)	(1,166)	(1,212)	(1,224)	(1,255)	(1,305)	(1,334)	(1,351)	(1,358)	(1,355)	(1,343)
Excess Cash	130	0	0	0	0	0	0	0	0	0	0	0	0
Post-retirement Benefits/(Liabilities)	642	642	642	642	642	642	642	642	642	642	642	642	642
<b>Net Financial Assets</b>	<b>(1,021)</b>	<b>(803)</b>	<b>(638)</b>	<b>(524)</b>	<b>(570)</b>	<b>(582)</b>	<b>(613)</b>	<b>(663)</b>	<b>(692)</b>	<b>(709)</b>	<b>(716)</b>	<b>(713)</b>	<b>(701)</b>

<b>Equity</b>	<b>2,681</b>	<b>2,555</b>	<b>2,521</b>	<b>2,567</b>	<b>2,589</b>	<b>2,621</b>	<b>2,640</b>	<b>2,632</b>	<b>2,633</b>	<b>2,634</b>	<b>2,634</b>	<b>2,634</b>	<b>2,633</b>
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## Attachment 3. Income Statement

Source: ER Analysis

GBP in millions	2019a	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Food Revenue	5,903	5,886	5,909	5,956	6,027	6,235	6,481	6,663	6,806	6,922	7,039	7,158	7,279
Clothing & Home Revenue	3,537	3,405	3,208	3,014	2,834	2,695	2,583	2,458	2,370	2,300	2,232	2,165	2,101
<b>UK Revenue</b>	<b>9,441</b>	<b>9,291</b>	<b>9,117</b>	<b>8,970</b>	<b>8,861</b>	<b>8,930</b>	<b>9,063</b>	<b>9,120</b>	<b>9,176</b>	<b>9,222</b>	<b>9,271</b>	<b>9,323</b>	<b>9,380</b>
<b>International Revenue</b>	<b>937</b>	<b>936</b>	<b>960</b>	<b>984</b>	<b>1008</b>	<b>1033</b>	<b>1044</b>	<b>1054</b>	<b>1065</b>	<b>1075</b>	<b>1086</b>	<b>1097</b>	<b>1108</b>
<b>Group Revenue</b>	<b>10,377</b>	<b>10,228</b>	<b>10,077</b>	<b>9,954</b>	<b>9,869</b>	<b>9,963</b>	<b>10,107</b>	<b>10,174</b>	<b>10,241</b>	<b>10,297</b>	<b>10,357</b>	<b>10,421</b>	<b>10,488</b>
Food Gross Profit	1,835	1,844	1,863	1,891	1,926	1,999	2,085	2,143	2,189	2,227	2,264	2,303	2,342
Clothing & Home Gross Profit	2,021	1,954	1,845	1,737	1,637	1,557	1,492	1,420	1,369	1,329	1,289	1,251	1,213
<b>UK Gross Profit Statutory</b>	<b>3,856</b>	<b>3,798</b>	<b>3,709</b>	<b>3,628</b>	<b>3,563</b>	<b>3,577</b>	<b>3,563</b>	<b>3,559</b>	<b>3,559</b>	<b>3,555</b>	<b>3,554</b>	<b>3,554</b>	<b>3,555</b>
Logistics Adjustment	(385)	(385)	(379)	(374)	(371)	(375)	(380)	(383)	(385)	(387)	(390)	(392)	(394)
<b>UK Gross Profit Adjusted</b>	<b>3,471</b>	<b>3,414</b>	<b>3,330</b>	<b>3,254</b>	<b>3,192</b>	<b>3,181</b>	<b>3,197</b>	<b>3,180</b>	<b>3,173</b>	<b>3,168</b>	<b>3,164</b>	<b>3,162</b>	<b>3,161</b>
<b>Group Gross Profit</b>	<b>3830</b>	<b>3,785</b>	<b>3,734</b>	<b>3,693</b>	<b>3,667</b>	<b>3,702</b>	<b>3,757</b>	<b>3,782</b>	<b>3,808</b>	<b>3,829</b>	<b>3,852</b>	<b>3,877</b>	<b>3,903</b>
Store Staffing	(1,045)	(1,066)	(1,053)	(998)	(996)	(994)	(992)	(990)	(990)	(990)	(990)	(990)	(990)
Other Store Costs	(950)	(929)	(912)	(897)	(886)	(886)	(906)	(912)	(918)	(922)	(927)	(932)	(938)
Distribution and Warehousing	(565)	(553)	(539)	(523)	(523)	(523)	(523)	(523)	(523)	(523)	(523)	(523)	(523)
Marketing	(155)	(171)	(188)	(206)	(226)	(245)	(262)	(276)	(282)	(282)	(282)	(282)	(282)
Central Costs	(695)	(691)	(688)	(684)	(684)	(684)	(684)	(684)	(684)	(684)	(684)	(684)	(684)
<b>Food &amp; C&amp;H Op. Costs</b>	<b>(3,410)</b>	<b>(3,410)</b>	<b>(3,380)</b>	<b>(3,309)</b>	<b>(3,316)</b>	<b>(3,333)</b>	<b>(3,369)</b>	<b>(3,386)</b>	<b>(3,398)</b>	<b>(3,403)</b>	<b>(3,408)</b>	<b>(3,413)</b>	<b>(3,418)</b>
<b>Food &amp; C&amp;H Op. Profit Stat.</b>	<b>446</b>	<b>388</b>	<b>329</b>	<b>319</b>	<b>247</b>	<b>223</b>	<b>208</b>	<b>177</b>	<b>160</b>	<b>153</b>	<b>146</b>	<b>141</b>	<b>137</b>
Logistics Adjustment	385	385	379	374	371	375	380	383	385	387	390	392	394
Adjusting Items	(400)	(248)	(124)	(62)	(31)	0	0	0	0	0	0	0	0
<b>Food &amp; C&amp;H Op. Profit Adj.</b>	<b>46</b>	<b>140</b>	<b>205</b>	<b>257</b>	<b>216</b>	<b>223</b>	<b>208</b>	<b>177</b>	<b>160</b>	<b>153</b>	<b>146</b>	<b>141</b>	<b>137</b>
<b>M&amp;S Bank Op. Profit</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>
Adjusting Items	(21)	(21)	(21)	0	0	0	0	0	0	0	0	0	0
<b>M&amp;S Bank Op. Profit Adjusted</b>	<b>7</b>	<b>7</b>	<b>7</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>	<b>28</b>
<b>M&amp;S Energy Op. Profit</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>UK Operating Profit Statutory</b>	<b>474</b>	<b>416</b>	<b>356</b>	<b>347</b>	<b>275</b>	<b>250</b>	<b>236</b>	<b>205</b>	<b>188</b>	<b>180</b>	<b>174</b>	<b>168</b>	<b>164</b>
<b>UK Op. Profit Adjusted</b>	<b>53</b>	<b>146</b>	<b>211</b>	<b>285</b>	<b>244</b>	<b>250</b>	<b>236</b>	<b>205</b>	<b>188</b>	<b>180</b>	<b>174</b>	<b>168</b>	<b>164</b>
<b>Statutory International Oper. Profit</b>	<b>127</b>	<b>126</b>	<b>129</b>	<b>132</b>	<b>136</b>	<b>139</b>	<b>140</b>	<b>142</b>	<b>143</b>	<b>145</b>	<b>146</b>	<b>147</b>	<b>149</b>
Adjusting Items	(17)												
<b>International Operating Profit</b>	<b>110</b>	<b>126</b>	<b>129</b>	<b>132</b>	<b>136</b>	<b>139</b>	<b>140</b>	<b>142</b>	<b>143</b>	<b>145</b>	<b>146</b>	<b>147</b>	<b>149</b>
<b>Group Operating Profit Statutory</b>	<b>601</b>	<b>541</b>	<b>485</b>	<b>479</b>	<b>411</b>	<b>389</b>	<b>376</b>	<b>347</b>	<b>331</b>	<b>325</b>	<b>320</b>	<b>316</b>	<b>313</b>
<b>Group Operating Profit Adjusted</b>	<b>162</b>	<b>272</b>	<b>340</b>	<b>417</b>	<b>380</b>	<b>389</b>	<b>376</b>	<b>347</b>	<b>331</b>	<b>325</b>	<b>320</b>	<b>316</b>	<b>313</b>
Finance Income	34	34	34	34	34	34	34	34	34	34	34	34	34
Finance Costs	(112)	(114)	(92)	(81)	(74)	(77)	(78)	(79)	(83)	(84)	(86)	(86)	(86)
<b>Statutory Profit Before Tax</b>	<b>523</b>	<b>462</b>	<b>428</b>	<b>432</b>	<b>371</b>	<b>346</b>	<b>323</b>	<b>301</b>	<b>282</b>	<b>274</b>	<b>268</b>	<b>264</b>	<b>261</b>
<b>Adj. Profit Before Tax</b>	<b>85</b>	<b>192</b>	<b>283</b>	<b>370</b>	<b>340</b>	<b>346</b>	<b>332</b>	<b>301</b>	<b>282</b>	<b>274</b>	<b>268</b>	<b>264</b>	<b>261</b>
Reported Taxes	(47)	(41)	(40)	(46)	(40)	(37)	(35)	(32)	(29)	(28)	(27)	(27)	(26)
<b>Reported Net Income</b>	<b>476</b>	<b>421</b>	<b>388</b>	<b>386</b>	<b>330</b>	<b>309</b>	<b>297</b>	<b>269</b>	<b>253</b>	<b>246</b>	<b>241</b>	<b>237</b>	<b>235</b>
Total Adjustments	(439)	(269)	(145)	(62)	(31)	0	0	0	0	0	0	0	0
<b>Adj. Net Income</b>	<b>37</b>	<b>152</b>	<b>243</b>	<b>324</b>	<b>299</b>	<b>309</b>	<b>297</b>	<b>269</b>	<b>253</b>	<b>246</b>	<b>241</b>	<b>237</b>	<b>235</b>
Other Comprehensive Income, net of tax	16	16	16	16	16	16	16	16	16	16	16	16	16
<b>Comprehensive Income</b>	<b>53</b>	<b>168</b>	<b>259</b>	<b>340</b>	<b>315</b>	<b>325</b>	<b>313</b>	<b>285</b>	<b>269</b>	<b>262</b>	<b>256</b>	<b>252</b>	<b>251</b>

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### Report Recommendations

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<b>Buy</b>	Expected total return (including expected capital gains and expected dividend yield) of more than 10% over a 12-month period.
<b>Hold</b>	Expected total return (including expected capital gains and expected dividend yield) between 0% and 10% over a 12-month period.
<b>Sell</b>	Expected negative total return (including expected capital gains and expected dividend yield) over a 12-month period.

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This report was prepared by Beatriz Leite and Bernardo Faria, Master in Finance students of Nova School of Business and Economics (“Nova SBE”), within the context of the Field Lab – Equity Research.

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This report was supervised by a Nova SBE faculty member, acting merely in an academic capacity, who revised the valuation methodology and the financial model.

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How to Price-In Ocado?

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A Project carried out on the Master in Finance Program, under the supervision of  
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## **Abstract**

Following its entry in the Online Groceries market, Marks & Spencer has entered a joint-venture agreement with Ocado Retail Group Plc. In the current paper, the potential of the joint-venture is analysed. Firstly, it is attempted to conclude if Marks & Spencer overpaid for the agreement. Secondly, it is analysed the potential signalling deriving from the economics of the deal.

## **Keywords**

Ocado, Marks & Spencer, Food, Online

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## **Motivation**

In February 2019, Marks & Spencer announced the creation of a joint-venture (JV) with Ocado Group Plc (“Ocado”). With M&S’s stock down c.12% on the day of the announcement, bulls and bears are monitoring closely the developments of this partnership as it marks the company’s definite shift towards an omnichannel model. Hence, the current analysis attempts to (1) assess the implied valuation of Ocado and (2) discuss the overall implications for M&S’s valuation from the new partnership.

## **Company Overview**

Trading on the London Stock Exchange since 2010, Ocado is a UK pure play online grocery retailer that operates via 2 segments – Solutions (8% of FY19 revenues) and Retail (92% of FY19 revenues). Through the Retail segment, Ocado reaches British consumers via its online platform, Ocado.com, offering them c.54,000 products. Leveraging on the expertise and data gathered from Retail, Ocado runs its Solutions segment - the company operates as an e-commerce partner, helping retail partners from several places of the world by using Ocado’s technology to develop its front-end interface. Under Solutions, each retail partner typically retains control of its customers and offers its own assortment and branded products.

Following its objective to enter the online groceries market, M&S is acquiring a 50% stake of Ocado’s UK Retail business, signing an agreement with the Solutions business via the Ocado Smart Platform. The agreement consists in the payment of a £750m consideration, which includes a deferred consideration of up to £187.5m plus interest, upon the meeting of targets not disclosed. The transaction will become effective in September 2020.

## **Assessing The Transaction Value**

### ***Comparable Transactions Analysis***

Firstly, to get a sense of (1) industry trends and (2) implied transaction values, a comparable transaction analysis was conducted. Several transactions were analysed, among which:

Date	Acquirer	Target	Description
05/08/2014	UK Retail Grocer	Online Book Community	Sainsbury acquires Anobii . Acquisition of 64% of the e-book platform HarperCollins and Penguin Random House stakes in Anovi for £1
31/03/2015	German Retail and Tourism Group	Cloud Commerce Platform	REWE acquires commercetools. Acquisition of 100%
12/04/2016	UK Online Grocer	SEA Online Retailer	Tesco sells partial stake in Lazada to Alibaba. Sale of 8.6% for US\$129mn
08/08/2016	American Conglomerate Retailer	American E-commerce Platform	Walmart acquires Jet.com. Acquisition for \$3 billion in cash, a portion of which will be paid over time, and \$300 million of Walmart shares
18/12/2017	Belgium Supermarket Chain	Belgian online pharmacy-related	Colruyt acquires NewPharma. Acquisition of 26% stake
02/04/2018	Chinese E-Commerce Conglomerate	C2C Meal Ordering Services	Alibaba acquires Ele.me. Acquisition of all outstanding shares of Ele.me (already held 43% of Ele.me) for \$9.5bn
12/04/2018	UK Retail Conglomerate	Swiss E-commerce Retailer	Siroop acquired Coop from Swisscom. Coop and Swisscom jointly launched Siroop
17/11/2018	Dutch Grocer	Online Retailer	Ahold Delhaize acquires bol.com. Acquisition of 100% for EUR350mn
21/12/2018	Dutch Food Delivery Platform	German Food Delivery Platform	Takeaway.com acquires Delivery Hero's German. Acquisition of an 18% stake for EUR930mn with EUR508mn being paid in cash
27/06/2019	German Supermarket Chain	Dutch Online Supermarket	Edeka increases stake in Picnic. Acquisition of 15% stake (already owned 20%)
25/10/2019	Food Delivery Platform	Food Delivery Platform	Foodhub buys Big Foodie

**Figure 1:** Comparable Transactions Identified as of Dec-2019

Given lack of data, it was not possible to collect information on the terms of each deal; also, in terms of deals, it was only possible to get revenue figures. The multiples of the transactions with publicly available information are presented in Figure 2. At first look at past transactions, Ocado seems to have been significantly cheaper than other similar players. However, there are some aspects to consider. Firstly, the transactions highlighted are both cash and stock while the Ocado-M&S deal is purely equity; with the premium in stock transactions being typically higher than all-cash transactions, we would expect Ocado's overall valuation to be higher than the other transactions analysed. Secondly, given the different stage of the retailer's value chain each player operates, the one transaction in which peers are more comparable to M&S is indeed the one between Ahold Delhaize<sup>1</sup> and bol.com<sup>2</sup>. And the transaction is exactly the one which is in-line with the underlying multiple associated with the transaction in analysis. Given the specificities of each deal, it would be deceiving to assume the comparable analysis transaction could sustain a conclusion by itself.

	Amount Paid (Implied EV)	Revenues	EV/Revenues Multiple	Stake
Walmart acquires Jet.com	USD3300m	USD550m	6.0x	100%
Ahold Delhaize acquires bol.com	EUR350m	EUR355m	1.0x	100%
Takeaway.com acquires Delivery Hero's German	USD70m	USD37.5m	1.9x	100%
<b>Marks &amp; Spencer acquires Ocado</b>	<b>EUR750m</b>	<b>EUR808m</b>	<b>0.9x</b>	<b>50%</b>
vs Median			-0.9x	
vs Average			-2.0x	

**Figure 2:** Comparable Transactions Analysis as of Dec-2019

<sup>1</sup> Leading food retailer in the Netherlands

<sup>2</sup> Leading online platform in the Netherlands for books, electronics and toys

## DCF Analysis

The DCF analysis implied a thorough analysis of Ocado and led to an overall valuation of £1.019 equity value (assuming a WACC of 7.6% and a terminal growth of 2.45% from 2030 onwards). Such valuation implies the impact in M&S's equity value is £509, reflecting c. 22% downside vs the amount paid (excluding the delayed consideration). In the current paper, the underlying assumptions of the Base Scenario are presented.

Ocado's Retail business model works purely online, meaning the company does not own nor operate physical stores, solely reaching the consumer via Ocado.com. Since the company's ability to generate revenues depends on its warehousing capacity, revenues were modelled taking into consideration the capacity per week of each customer fulfilment centre (CFC), capacity utilization and an average order size. In specific, the following was assumed to obtain the capacity of each CFC:

	Description	Assumption
CFC1 - Hatfield	Started operating in 2002 with capacity for 165 orders per week.	Since it is operating for so long, assumed entire capacity is available
CFC2 - Dordon	Started operating in 2013 with capacity for 190 orders per week.	Since it is operating for so long, assumed entire capacity if available.
CFC3 - Andover	Built in 2016 with capacity for 30 orders per week. Suffered a fire in 2019 and capacity was not at its full at the time of the event.	Not expected to open in 2020; expected to reach full capacity of 65 orders per week in 2021.
CFC4 - Erith	Started operating in 2019 with only half capacity availability.	Overall capacity of 70 orders per week to be available in 2020.
CFC5 - Purfleet	In construction.	Expected to start operating in 2021 with only half capacity available. Overall capacity of 85 orders per week fully available in 2022
CFC6 - Bristol	Announced.	Expected to start operating in 2022 with only half capacity available. Overall capacity of 85 orders per week available in 2022

**Figure 3:** Ocado's CFC Capacity Availability as of 2019

Following Ocado's plans to open more customer fulfilment centres of smaller size, it was assumed each year the company will be adding 15 orders per week to Ocado's capacity – the equivalent to adding a mini-CFC (similar to Bristol) which is only fully operational in year 2 to the company's weekly capacity. On top of this and following Morrisons ending the partnership with Ocado<sup>3</sup> and partnering with Amazon, it was assumed not all capacity was allocated to M&S (instead to Morrisons) but also that such capacity is decreasing throughout time. Costs were modelled taking into consideration the company's impact in gross margin

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<sup>3</sup> Morrisons is one of Ocado's Solutions clients. Under the partnership, Morrisons shares capacity with Ocado's retail segment in some of the British CFCs

following the end of the payment of the sourcing fees to Waitrose, implying +99 bps in FY'20. Additionally, given Ocado's major operating costs are associated with the CFCs and Trunking and Delivery, these lines were modelled assuming the company will obtain economies of scale, which translate in efficiency gains until 2023, stable from then onwards. Capital expenditures were modelled as a function of sales (since sales are a function of CFCs).

At this point, information on customer loyalty following the end of the agreement with Waitrose and the ability to integrate businesses is still unknown; as such, this valuation can be considered fairly optimistic as it accounts for little negative impact from the transition. Overall, the little disruption from the deal provides a fairly reasonable valuation following the risks associated with a SELL recommendation on Marks & Spencer and allows to conclude the UK retailer overpaid for the deal.

**Running More Numbers**

To finance the transaction, M&S announced both a dividend reset of 40% (with dividend falling from 18.7p to 13.9p) as well as a rights issue. While it is understandable such transaction implies financial discipline from M&S, it would be expected the company would compensate its investors for their patience in a context in which its stock deteriorating performance. A dividend reset certainly resonates in the mind's of M&S's investors as, historically, dividends are fairly stable at least since 2010.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
DPS	15.0	17.0	17.0	17.0	17.0	18.0	18.7	18.7	18.7	18.7	13.9
%		13.3%	0.0%	0.0%	0.0%	5.9%	3.9%	0.0%	0.0%	0.0%	-25.7%

**Figure 3:** M&S's dividend per share. Excludes special dividend of 6.4p paid in 2017

If we run the numbers we get that the transaction was able to finance c. £600mn and the dividend reset a further c.£60m. In this scenario, one could raise its concerns over management's beliefs, with the rights issue to finance the transaction not being enough for the company. Alternatively, following management's revamping of capital expenditure to £350mn (from 3% of total group sales to 3.5%), investors could become even more worried on the high level of invested capital.

Overall, the (1) financing method, which consisted in an undersubscribed rights issue<sup>4</sup>, (2) the dividend cut and (3) increasing capital expenditures combined can lead to increasing investors' mistrust – and, indeed, on the day of the announcement, Marks & Spencer's stock price decreased by more than the equivalent value of the expected gross synergies generated following the agreement (£70mn).

### **It is about reputation**

M&S is full of soft spots. With a Food business not promising major upturns and a declining Clothing & Home segment, the company is lacking real growth drivers. Lagging behind competition, the company fails to (1) conquer its consumer and (2) build trust with its investors. M&S has become reactive, rather than proactive, in a market that fights for thin margins. Entering the online market, years after its competitors were playing cards, is nothing but a desperate move to provide some signs of life. If the agreement with Ocado was golden, then we would expect Waitrose to bid to enter as well, instead of partnering with Amazon. The price is only indicative of a desperate management team with little growth opportunities to make the business thrive, ignoring the significant execution risks of the transaction. As such, the current analysis only reinstates the belief on the SELL recommendation.

In the end of the day, Marks & Spencer paid for the transaction with the loss of investors' trust.

Volatility will follow. Was it really worth it?

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<sup>4</sup> Vs average 91% subscription in the sector